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United States
Circuit Court of Appeals
for the Ninth Circuit

Vol. 1
~~2315~~
2316

DAILY JOURNAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of Record


Upon Petition to Review a Decision of the Tax Court of
the United States.

FILED

OCT 30 1942

PAUL P. O'BRIEN,

CLERK



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United States
Circuit Court of Appeals
for the Ninth Circuit

DAILY JOURNAL COMPANY,

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

For Appellant:

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Attorneys for Petitioner and Appellant.

For Appellee:

J. P. Wenchel, Chief Counsel,

Alva C. Baird, Division Counsel,

Frank C. Horner, Special Attorney,

E. A. Tonjes, Special Attorney,

Bureau of Internal Revenue, Washington, D. C.,

Attorneys for Appellee. [1*]

*Page numbering appearing at top of page of original Reporter's Transcript.

TRANSCRIPT OF RECORD

UNITED STATES CIRCUIT COURT OF APPEALS
NINTH CIRCUIT

DAILY JOURNAL COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

UPON PETITION TO REVIEW A DECISION OF
THE UNITED STATES BOARD OF
TAX APPEALS

[3]

UNITED STATES BOARD OF TAX APPEALS

Docket No. 105054

Daily Journal Company,

Petitioner,

v.

Commissioner of Internal Revenue,

Respondent.

PETITION

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency

IT:LA PB-90D dated July 3, 1940, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation, organized under the laws of the State of California with office at 121 North Broadway, Los Angeles, California.
2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on July 3, 1940.

[4]

3. The taxes in controversy are income taxes for the taxable years ended December 31, 1936, December 31, 1937 and December 31, 1938 in the amount of \$917.92 (more or less) and personal holding company surtaxes for the taxable years ended December 31, 1937 and December 31, 1938 in the amount of \$12,796.31 (more or less).
4. That deficiency assessments as to year 1938 are accepted by petitioner in the following amounts:

<u>Income Tax</u>	<u>Surtax</u>	<u>Total</u>
\$73.13	\$2,459.05	\$2,532.18
=====	=====	=====

Deficiency assessments as to the years 1936, 1937, 1938 are contested in the following amounts:

	<u>Income Tax</u>	<u>Surtax</u>	<u>Total</u>
1936	\$ 80.85	—	80.85
1937	409.50	5,616.98	6,026.48
1938	427.57	7,179.33	7,606.90
	=====	=====	=====
Totals	\$917.92	12,796.31	13,714.23
	=====	=====	=====

5. The determination of that portion of additional assessment of taxes as set forth in the said [5] notice of deficiency is based upon the following errors:
- a. The respondent erred in determining that the amount of \$12,000.00 constitutes an excessive salary allowance or other compensation paid for personal services actually rendered by Douglas W. Wilson to Daily Journal Company for each of the taxable years 1936, 1937, 1938.
 - b. The respondent erred in determining that the difference between \$2,000.00, which the respondent claims to have been a reasonable salary allowance for each of the years in question, and \$12,000.00, which was paid by petitioner, did not constitute a dividend distribution in determining income subject to personal holding company surtax.
6. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

[6]

4.

- A. That Douglas W. Wilson was President of Daily Journal Company during the years 1936, 1937 and 1938, and had held that office continuously since May 3, 1917, on which date he was elected to that office.
- B. That on May 3, 1917, by resolution of the directors of petitioner corporation, as contained in minutes of meeting held on that date, the salary of the President was reduced from \$24,000.00 per annum to \$12,000.00 per

annum, and that arrangement has continued to date.

- C. That the services of Douglas W. Wilson, for which an annual compensation of \$12,000.00 was paid in the calendar years 1936, 1937, 1938, were fully worth \$12,000.00 per annum and were rendered to Daily Journal Company, petitioner herein, and that the compensation paid was a duly authorized, ordinary and necessary expense of the business.
- D. That services rendered by Douglas W. Wilson to Consolidated Printing and Publishing Company, a subsidiary corporation, were in fact rendered to petitioner corporation, inasmuch as the main income of petitioner corporation was directly dependent upon the earnings of said subsidiary.
- E. That Douglas W. Wilson held no stock in Consolidated Printing and Publishing Company, a subsidiary corporation, other than one qualifying share, and that there was no motive or inducement for Douglas W. Wilson to render any services to said subsidiary other than to secure an income for the parent company.
- F. That if any portion of the \$12,000.00 paid to Douglas W. Wilson as a salary is disallowed for any of the taxable years, then the disallowed portion constitutes a dividend paid pro-rata to or for the benefit of all the shareholders but by the orders of the shareholders other than Douglas W. Wilson the amounts to which they were entitled were paid to him.

[8] Wherefore the petitioner prays that this Board may hear the proceeding and disallow the deficiency as asserted by the Commissioner, except in so far as said deficiency is admitted.

The petitioner further requests that a hearing may be had in the case in the City of Los Angeles, California.

Walter C. Wright
Walter C. Wright
Counsel for Petitioner
510 South Spring Street
Los Angeles, California

State of California
County of Los Angeles—ss.

William W. Roe, being duly sworn, says that he is Secretary of Daily Journal Company, petitioner corporation, that he is duly authorized to verify the foregoing petition, that he has read the foregoing petition, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated upon information and belief, and those facts he believes to be true.

William W. Roe

Subscribed and sworn to before me this 26th day of Sept., 1940.

[Seal]

Chas. D. Roe

Notary Public in and for said
County and State.

[9]

EXHIBIT "A"

[10]

TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE

Twelfth Floor

U. S. Post Office and Courthouse
LOS ANGELES, CALIF.

Office of
INTERNAL REVENUE AGENT IN CHARGE
Los Angeles Division

IT:LA

PB-90D

July 3, 1940

Daily Journal Company,
121 North Broadway,
Los Angeles, California.

Sirs:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1936, December 31, 1937, and December 31, 1938, discloses a deficiency of \$991.05, and that the determination of your personal holding company surtax liability for the taxable years ended December 31, 1937, and December 31, 1938, discloses a deficiency of \$15,255.36, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a re-determination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, Los Angeles, California, for the attention of IT:LA:FC. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

Guy T. Helvering,

Commissioner,

By

GEORGE D. MARTIN

Internal Revenue Agent in Charge.

Enclosures:

Statement.

Form of waiver.

[11]

STATEMENT

IT:LA
PB-90DDaily Journal Company,
121 North Broadway,
Los Angeles, California.Tax Liability for the Taxable Years Ended
December 31, 1936,
December 31, 1937
and
December 31, 1938

Year	Liability	Assessed	Deficiency
	Income Tax		
1936	\$ 80.85	None	\$ 80.85
1937	409.50	None	409.50
1938	753.28	\$252.58	500.70
	<hr/>	<hr/>	<hr/>
Totals	\$ 1,243.63	\$252.58	\$ 991.05

Personal Holding Company Surtax

1937	\$ 5,616.98	None	\$ 5,616.98
1938	9,638.38	None	9,638.38
	<hr/>	<hr/>	<hr/>
Totals	\$15,255.36	None	\$15,255.36

In making this determination of your income tax and personal holding company surtax liability, careful consideration has been given to the report of examination dated December 12, 1939, to your protests dated January 27 and May 18, 1940, and to the statements made at the conferences held on February 21 and May 20, 1940.

It is held that the amount of \$2,000.00 constitutes a reasonable salary allowance or other compensation paid for personal services actually rendered to you by Douglas W. Wilson for each of the taxable years 1936, 1937 and 1938. Section 23(a), Revenue Acts of 1936 and 1938. Since you claimed a deduction in your return for each of these taxable years in the amount of \$12,000.00, the amount of \$10,000.00 is disallowed for each of these taxable years.

[12]

- 2 -

Daily Journal Company.

Statement.

If you do not acquiesce in all of the adjustments making up the deficiencies indicated, but desire to stop the accumulation of interest on that part of the deficiencies resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amounts of the deficiencies you desire to have assessed at once. The execution of the form for the agreed portion of the deficiencies will not deprive you of your right to petition the United States Board of Tax Appeals for a redetermination of the deficiencies.

A copy of this letter and statement has been mailed to your representative, Mr. Walter C. Wright, 510 South Spring Street, Los Angeles, California, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1936

Net Income as disclosed by return	\$18,849.42
Unallowable deduction:	
(a) Excessive salary	10,000.00
	<hr/>
Total	\$28,849.42
Additional deduction:	
(b) Cancellation of bond	1,000.00
	<hr/>
Net income adjusted	\$27,849.42
[13]	

- 3 -

Daily Journal Company. Statement.

EXPLANATION OF ADJUSTMENTS

(a) For the reason stated above the excessive salary deduction in the amount of \$10,000.00 is disallowed.

(b) During the taxable year a bond of David P. Stone Company, which cost you \$1,000.00, was cancelled upon the payment to you of \$175.00. You included the latter amount in your gross income but did not deduct the loss sustained. Accordingly a deduction of \$1,000.00 is allowed.

COMPUTATION OF INCOME TAX

Taxable Year Ended December 31, 1936

Normal Tax

Taxable net income	\$27,849.42
Less: Dividends received credit, 85% of \$31,575.12	26,838.85
	<hr/>
Normal tax net income	\$ 1,010.57

Normal tax:

8% of \$1,010.57 \$80.85

Total normal tax \$80.85

Surtax on Undistributed Profits

Taxable net income \$27,849.42

Less: Normal tax 80.85

Adjusted net income \$27,768.57

Less: Dividends paid credit 33,000.00

Undistributed net income None

Surtax None

Total surtax None

Total normal tax \$80.85

Total income tax (normal tax and surtax) \$80.85

Income tax assessed (normal tax and surtax):

Original, account No. 851738 None

Deficiency of income tax \$80.85

[14]

- 4 -

Daily Journal Company.

Statement.

ADJUSTMENT TO NET INCOME

Taxable Year Ended December 31, 1937

Net income as disclosed by return \$27,165.47

Unallowable deduction:

Excessive salary 10,000.00

Net income adjusted \$37,165.47

EXPLANATION OF ADJUSTMENT

For the reason previously stated the excessive salary deduction of \$10,000.00 is disallowed.

COMPUTATION OF TAX

Taxable Year Ended December 31, 1937

INCOME TAX

Normal Tax

Taxable net income		\$37,165.47
Less: Dividends received credit, 85% of \$40,735.00		34,624.75
		<hr/>
Normal tax net income		\$ 2,540.72
Normal tax:		
8% of \$2,000.00	\$160.00	
11% of \$ 540.72	59.48	
	<hr/>	
Total Normal Tax		\$ 219.48
[15]		

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Daily Journal Company. Statement.

INCOME TAX (Continued)

Surtax on Undistributed Profits

Taxable net income		\$37,165.47
Less: Normal tax		219.48
		<hr/>
Adjusted net income		\$36,945.99
Less: Dividends paid credit:		
Dividends paid during the taxable year	\$29,000.00	
Dividend carry-over from preceding taxable year	5,231.43	34,231.43
	<hr/>	<hr/>
Undistributed net income		\$ 2,714.56

Surtax:

7% of \$2,714.56 \$ 190.02

Total surtax \$ 190.02

Total normal tax 219.48

Total income tax (normal tax and surtax) \$ 409.50

Income tax assessed (normal tax and surtax):

Original, account No. 852608 None

Deficiency of income tax \$ 409.50

[16]

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Daily Journal Company.

Statement.

PERSONAL HOLDING COMPANY SURTAX

Taxable net income \$37,165.47

Less: Federal income tax 409.50

Adjusted net income \$36,755.97

Less: Dividends paid credit 29,000.00

Undistributed adjusted net income \$ 7,755.97

Personal holding company surtax:

65% of \$2,000.00 \$1,300.00

75% of 5,755.97 4,316.98

Total personal holding company surtax \$ 5,616.98

Personal holding company surtax assessed:

Original, account No. 880134 None

Deficiency of personal holding company surtax \$ 5,616.98

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1938

Net income as disclosed by return		\$13,471.12
Unallowable deductions:		
(a) Excessive salary	\$10,000.00	
(b) Bad debts	3,900.00	13,900.00
	<hr/>	<hr/>
Net income adjusted		\$27,371.12

EXPLANATION OF ADJUSTMENTS

(a) For the reason previously stated the excessive salary deduction of \$10,000.00 is disallowed.

(b) No ascertainment of worthlessness was made within the taxable year within the meaning of section 23(k) of the Revenue Act of 1938 with respect to \$3,900.00 bonds, claimed in your return as bad debts. The deduction claimed is therefore disallowed.

[17]

- 7 -

Daily Journal Company.

Statement.

COMPUTATION OF TAX

Taxable Year Ended December 31, 1938

Income Tax

Tax under General Rule

Taxable net income		\$27,371.12
Adjusted net income		\$27,371.12
Tentative tax: 19% of \$27,371.12		\$ 5,200.51
Less: 16½% of 85% of \$27,371.12		
dividends received credit	\$3,838.80	
2½% of \$13,500.00		
dividends paid credit	337.50	4,176.30
	<hr/>	<hr/>
Total income tax under general rule		1,024.21

Alternative Tax

Taxable net income		\$27,371.12
First division income		\$25,000.00
Second division income		\$ 2,371.12
Tax on first division:		
First division income	\$25,000.00	
Less: 85% of dividends received, not in excess of 85% of first division income	21,250.00	
		<hr/>
Special class net income	\$ 3,750.00	
Tax at 12½% on \$3,750.00	\$ 468.75	
Total tax on first division		\$ 468.75
Tax on second division:		
Second division income	\$ 2,371.12	
Dividends received allocated to second division	2,371.12	
Tax at 12% on \$2,371.12	\$ 284.53	
Total tax on second division		\$ 284.53
		<hr/>
Total income tax under alternative rule		\$ 753.28
Correct income tax liability		\$ 753.28
Income tax assessed:		
Original, account No. 410663		252.58
		<hr/>
Deficiency of income tax		\$ 500.70

[18]

- 8 -

Daily Journal Company, Statement.

PERSONAL HOLDING COMPANY SURTAX

Taxable net income \$27,371.12

Less: Federal income tax 753.28

Title 1A net income \$26,617.84

Less: Dividends paid credit 13,500.00

Undistributed Title 1A net income \$13,117.84

Personal holding company surtax:

65% of \$ 2,000.00 \$1,300.00

75% of 11,117.84 8,338.38

Total personal holding company surtax \$ 9,638.38

Personal holding company surtax assessed:

Original, account No. 880169 None

Deficiency of personal holding company surtax \$ 9,638.38

[Stamped]: United States Board of Tax Appeals,
Oct. 2, 1940.

[19]

UNITED STATES BOARD OF TAX APPEALS

Docket No. 105054

Daily Journal Company,

Petitioner,

v.

Commissioner of Internal Revenue,

Respondent.

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits that the taxes in controversy are income taxes for the calendar years 1936, 1937 and 1938, and personal holding company surtaxes for the years 1937 and 1938; denies remainder of the allegations contained in paragraph 3 of the petition.

4. Respondent neither admits nor denies the allegations contained in paragraph 4 of the petition.

5. Denies the allegations of error contained in subparagraphs (a) and (b) of paragraph 5 of the petition.

6. (a) Admits the allegations of fact contained in subparagraph (a) of paragraph 6 of the petition.

[20] (b) to (f), inclusive. Denies the allegations contained in subparagraphs (b) to (f), inclusive, of paragraph 6 of the petition.

7. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

Signed J. P. Wenchel
FTH

J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:

Alva C. Baird,
Division Counsel.

Frank T. Horner,
E. A. Tonjes,
Special Attorneys,
Bureau of Internal Revenue.

EAT/fmt 11/19/40

[Stamped] Received Nov. 26, 1940. U. S. Board of
Tax Appeals.

Filed Nov. 26, 1940. United States Board of Tax
Appeals.

UNITED STATES BOARD OF TAX APPEALS

Docket No. 105054

Daily Journal Company,

Petitioner,

v.

Commissioner of Internal Revenue,

Respondent,

AMENDMENTS TO PETITION

Petitioner in above cited case desires to amend its petition in the following particulars:

To amend Paragraph 3 to read as follows:

The taxes in controversy are income taxes for the taxable years ended December 31, 1936, December 31, 1937 and December 31, 1938 in the amount of \$938.85 (more or less) and personal holding company surtaxes for the taxable years ended December 31, 1937 and December 31, 1938 in the amount of \$15,255.36 (more or less).

[22] To amend Paragraph 4 to read as follows:

That deficiency assessments as to year 1938 are accepted by petitioner in the following amounts:

<u>Income Tax</u>	<u>Total</u>
\$52.50	\$52.50
=====	=====

Deficiency assessments as to the years 1936, 1937, 1938 are contested in the following amounts:

	<u>Income Tax</u>	<u>Surtax</u>	<u>Total</u>
1936	\$ 80.85	—	80.85
1937	409.50	5,616.98	6,026.48
1938	448.50	9,638.38	10,086.88
	=====	=====	=====
Totals	\$938.85	15,255.36	16,194.21
	=====	=====	=====

To add Paragraphs 5c and 5d:

- 5c. The respondent erred in failing to allow a capital loss of \$930.00 on the exchange of a bond in Breakers Hotel.
- 5d. The respondent erred in proposing to assess excess profits tax upon any amounts claimed by respondent to have been unlawfully deducted from income by petitioner in the years 1937 and 1938.

[23] To add Paragraphs 6G and 6H:

- 6G. That in 1929 petitioner purchased for \$1,000.00 a bond in Breakers Hotel. This bond had a fair market value on January 1, 1938. In the year 1938 petitioner exchanged the bond for 10 shares of stock of 200 East Ocean Boulevard Company in a realizing exchange; said stock having a total value of \$70.00. Petitioner realized capital loss of \$930.00 which is fully deductible.
- 6H. That petitioner corporation has consistently distributed all of its earnings: that it has never been availed of for accumulating earnings: that the legislative history behind the Personal Holding Company surtax law demonstrates the intention of the statute to be the prevention of the accumulation of surplus earnings: that to impose the tax upon deductions erroneously made in the preparation of tax returns would be to misinterpret the intention of the law.

Petition as thus amended is presented in the following:

[24] AMENDED PETITION

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:LA PB-90D dated July 3, 1940, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation, organized under the laws of the State of California with office at 121 North Broadway, Los Angeles, California.
2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on July 3, 1940.
3. The taxes in controversy are income taxes for the taxable years ended December 31, 1936, December 31, 1937 and December 31, 1938 in the amount of \$938.85 (more or less) and personal holding company surtaxes for the taxable years ended December 31, 1937 and December 31, 1938 in the amount of \$15,255.36 (more or less).

[25]

4. That deficiency assessments as to year 1938 are accepted by petitioner in the following amounts:

<u>Income Tax</u>	<u>Total</u>
\$52.50	\$52.50
<u> </u>	<u> </u>

Deficiency assessments as to the years 1936, 1937, 1938 are contested in the following amounts:

	<u>Income Tax</u>	<u>Surtax</u>	<u>Total</u>
1936	\$ 80.85	—	80.85
1937	409.50	5,616.98	6,026.48
1938	448.50	9,638.38	10,086.88
	<u> </u>	<u> </u>	<u> </u>
Totals	\$938.85	15,255.36	16,194.21
	<u> </u>	<u> </u>	<u> </u>

5. The determination of that portion of additional assessment of taxes as set forth in the said notice of deficiency is based upon the following errors:

- a. The respondent erred in determining that the amount of \$12,000.00 constitutes an excessive salary allowance or other compensation paid for personal services actually rendered by Douglas W. Wilson to Daily Journal [26] Company for each of the taxable years 1936, 1937, 1938.
- b. The respondent erred in determining that the difference between \$2,000.00, which the respondent claims to have been a reasonable salary allowance for each of the years in question, and \$12,000.00, which was paid by petitioner, did not constitute a dividend distribution in determining income subject to personal holding company surtax.
- c. The respondent erred in failing to allow a capital loss of \$930.00 on the exchange of a bond in Breakers Hotel.
- d. The respondent erred in proposing to assess excess profits tax upon any amounts claimed by respondent to have been unlawfully deducted from income by petitioner in the years 1937 and 1938.

6. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

[27]

- A. That Douglas W. Wilson was President of Daily Journal Company during the years 1936, 1937 and 1938, and had held that of-

fice continuously since May 3, 1917, on which date he was elected to that office.

- B. That on May 3, 1917, by resolution of the directors of petitioner corporation, as contained in minutes of meeting held on that date, the salary of the President was reduced from \$24,000.00 per annum to \$12,000.00 per annum, and that arrangement has continued to date.
- C. That the services of Douglas W. Wilson, for which an annual compensation of \$12,000.00 was paid in the calendar years 1936, 1937, 1938, were fully worth \$12,000.00 per annum and were rendered to Daily Journal Company, petitioner herein, and that the compensation paid was a duly authorized, ordinary and necessary expense of the business.
- D. That services rendered by Douglas W. Wilson to Consolidated Printing and Pub- [28]
lishing Company, a subsidiary corporation, were in fact rendered to petitioner corporation, inasmuch as the main income of petitioner corporation was directly dependent upon the earnings of said subsidiary.
- E. That Douglas W. Wilson held no stock in Consolidated Printing and Publishing Company, a subsidiary corporation, other than one qualifying share, and that there was no motive or inducement for Douglas W. Wilson to render any services to said subsidiary other than to secure an income for the parent company.

- F. That if any portion of the \$12,000.00 paid to Douglas W. Wilson as a salary is disallowed for any of the taxable years, then the disallowed portion constitutes a dividend paid pro-rata to or for the benefit of all the shareholders, but by the orders of the shareholders, other than Douglas W. Wilson the amounts to which they were entitled were paid to him.

[29]

- G. That in 1929 petitioner purchased for \$1,000.00 a bond in Breakers Hotel. This bond had a fair market value on January 1, 1938. In the year 1938 petitioner exchanged the bond for 10 shares of stock of 200 East Ocean Boulevard Company in a realizing exchange; said stock having a total value of \$70.00. Petitioner realized capital loss of \$930.00 which is fully deductible.

- H. That petitioner corporation has consistently distributed all of its earnings: that it has never been availed of for accumulating earnings: that the legislative history behind the Personal Holding Company surtax law demonstrates the intention of the statute to be the prevention of the accumulation of surplus earnings: that to impose the tax upon deductions erroneously made in the preparation of tax returns would be to misinterpret the intention of the law.

[30] Wherefore the petitioner prays that this Board may hear the proceeding and disallow the deficiency as asserted by the Commissioner, except in so far as said deficiency is admitted.

The petitioner further requests that a hearing may be had in the case in the City of Los Angeles, California.

The petitioner further states that copy of Notice of Deficiency was presented with petition as originally filed.

Walter C. Wright

Walter C. Wright

Counsel for Petitioner

510 South Spring Street

Los Angeles, California

State of California

County of Los Angeles—ss.

William W. Roe, being duly sworn, says that he is Secretary of Daily Journal Company, petitioner corporation, that he is duly authorized to verify the foregoing petition, that he has read the foregoing petition, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated upon information and belief, and those facts he believes to be true.

William W. Roe

Subscribed and sworn to before me this 17th day of February, 1941.

[Seal]

Chas. D. Roe

Notary Public in and for said
County and State.

[Stamped]: Lodged Feb. 24, 1941. United States Board of Tax Appeals.

Filed at Hearing Mar. 26, 1941. U. S. Board of Tax Appeals.

[31]

[Title of Board of Tax Appeals and Cause.]

ANSWER TO AMENDED PETITION

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the amended petition of the above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the amended petition.

3. Admits that the taxes in controversy are income taxes for the calendar years 1936, 1937 and 1938, and personal holding company surtaxes for the years 1937 and 1938; denies the remainder of the allegations contained in paragraph 3 of the amended petition.

4. Respondent neither admits nor denies the allegations contained in paragraph 4 of the amended petition.

5. Denies the allegations of error contained in subparagraphs (a) to (d), inclusive, of paragraph 5 of the amended petition.

6. (A) Admits the allegations contained in subparagraph (A) [32] of paragraph 6 of the amended petition.

(B) to (H), inclusive. Denies the allegations contained in subparagraphs (B) to (H), inclusive, of paragraph 6 of the amended petition.

7. Denies each and every allegation contained in the amended petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

(Signed) J. P. Wenchel

FTH

J. P. WENCHEL,

Chief Counsel,

Bureau of Internal Revenue.

Of Counsel:

Alva C. Baird,

Division Counsel.

Frank T. Horner,

E. A. Tonjes,

Special Attorneys,

Bureau of Internal Revenue.

EAT/ma 4/23/41

[Stamped]: Received Apr. 29, 1941. U. S. Board of Tax Appeals.

Filed Apr. 29, 1941. United States Board of Tax Appeals

[33]

EXCERPTS FROM THE TRANSCRIPT OF
TESTIMONY
(RE AMENDMENTS TO THE AMENDED
PETITION)

Mr. Latham: I would like at this time to move to amend those provisions of the amended petition to read as follows, if I may do so.

The Member: Dictate it into the record.

Mr. Latham: I move that paragraph 5c of the amended petition be amended so as to read as follows:

"The respondent erred in failing to allow petitioner a deduction of at least \$930 for the calendar year 1938 as a bad debt or loss in connection with the disposition in 1938 of a bond issued by the Long Beach Hotel Company covering property known as the Breakers Hotel."

And petitioner moves that paragraph 6g of the amended petition be amended so as to read as follows:

"That in 1929 petitioner purchased for \$1,000 a bond issued by the Long Beach Hotel Company of Long Beach, California, covering property known as the Breakers Hotel. Said bond was not worthless on December 31, 1937. During the year 1938 petitioner turned in said bond, receiving therefor 10 shares of the stock of the corporation known as 200 East Ocean Boulevard Company, which stock at the time of receipt and on December 31, 1938, had a fair market value of not in excess of \$70. On account of said transaction petitioner sustained a loss

during the calendar year 1938 in an amount of not less than \$930, which loss was deductible as a bad debt or otherwise in determining net taxable income for that year."

The final issue in the proceeding—

The Member: Just a moment. Is there any objection to this amendment:

[34] Mr. Tonjes: I have no objection to the amendment, your Honor. However, I would like to have the record show at this time that respondent denies the allegations of fact contained in the amendment.

The Member: Let the record be considered amended as to the petition as dictated by petitioner's counsel, and that the record be considered as containing a general denial of the amended allegations on the part of respondent.

[35]

[Title of Board of Tax Appeals and Cause.]

Dana Latham, Esq., and Walter C. Wright, Esq., for the petitioner.

W. A. Tonjes, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

Disney: The Commissioner determined deficiencies in income taxes for the years 1936, 1937 and 1938 in the respective amounts of \$80.85, \$409.50 and \$500.70, and personal holding company surtaxes for the years 1937 and 1938 in the respective amounts of \$5,616.98 and \$9,638.38.

The issues presented are the following: (1) What is reasonable compensation to Douglas W. Wilson in each of the years 1936, 1937 and 1938, for the services then performed by him for the petitioner; (2) whether any portion of the amounts paid Wilson in those years by the petitioner and claimed by it as a deduction, as compensation for an officer, a portion of which was [36] disallowed by the respondent, constitutes a distribution of dividend; and (3) did the petitioner sustain a deductible loss, and if so, the amount thereof, on the exchange of a Breakers Hotel \$1,000 bond for 10 shares of the capital stock of 200 East Ocean Boulevard Company?

The evidence consists of the deposition of Douglas W. Wilson, numerous exhibits and a stipulation of certain facts, which are adopted as a part of our findings of fact and so far as deemed material to the determination of the issues, summarized herein.

The petitioner's income tax returns for the taxable years were filed with the Collector at Los Angeles, California.

FINDINGS OF FACT.

In 1893 one Warren Wilson acquired an unincorporated business called the Daily Journal Company which published the Los Angeles Daily Journal, a California daily newspaper which specialized in legal news. In 1895 the enterprise was incorporated under the laws of the State of California, as the Daily Journal Company, which corporation is the petitioner herein.

Warren Wilson acted as president of the corporation from the date of its incorporation to the date of his death, in 1917, at which date and for several years prior thereto, he, as the president thereof, received a salary of \$24,000 a year.

In 1917, after the death of Warren Wilson, Douglas W. Wilson, a son, (hereinafter referred to as "Wilson"), who had been connected with the company for a number of years, was elected president thereof and the salary of the president was by resolution of the stockholders reduced from \$24,000 to \$12,000 a year, at which it has continued, no further corporate action being [37] taken with respect thereto. During the taxable years, 1936-1938, inclusive, petitioner paid no officers' salary to anyone except Wilson.

During the year 1929 and for several years prior thereto there was serious competition in the legal news and advertising business, in which petitioner was engaged, between it and the Los Angeles News, the California Independent, the Los Angeles Review, and the Greater Los Angeles, which unfavorably affected the income of all the said newspapers. At that time the Daily Journal Company, the petitioner, was doing about two-thirds of the available legal publishing business in Los Angeles.

The matter of forming a new corporation was discussed by the representatives of the several newspapers mentioned, resulting in 1929 in the incorporation of the Consolidated Printing & Publishing Company, frequently herein called the "Consolidated," the capital stock of which was issued in exchange for the assets, good will and business of the concerns forming the Consolidated. In connection with the formation of the new corporation, the Consolidated, the parties interested and involved executed certain written agreements indicating therein the general tenor of the proposed consolidation and the interests of the respective parties in the consolidated enterprise.

The parties to the consolidation understood and agreed that Wilson, who was the president of the Daily Journal Company, would become and continue to act, as the president and general manager of the Consolidated. The understanding and agreement described and the execution of the duties imposed on Wilson thereby existed and were discharged by Wilson throughout the years 1936, 1937 and 1938.

After the organization of the Consolidated was completed, the newspapers then composing the same, but continuing under their own names, were [38] printed and published by the Consolidated and this situation existed throughout the years 1936, 1937 and 1938.

The stock of the Consolidated Printing & Publishing Company in 1929 was issued in amounts indicated in the schedule below and in the taxable years was held as also shown therein:

Name of Stockholder	Shares Received upon Consolidation in 1929			Shares Held In 1936, 1937 and 1938		
	"Class A" Pfd.	"Class B" Pfd.	Common	"Class A" Pfd.	"Class B" Pfd.	Common
L. A. Journal Group :						
Daily Journal Company	551	3258	2340		3258	2340
L. A. News Group :						
Legal Publishing Com- pany	161	1086	780			
C. A. Page					387	560
Marietta Page					193	
Chas. A. Page, Jr.					193	
G. V. Allen					157	110
Ethel Allen					156	110
Calif. Independent group :						
Dan W. Green	85	469	272		469	272
Marie McManus	3	63	36		63	36
Elmar Riggins		62	36			
Forrest A. Riggins					62	36
Kathryn G. Lawson		62	36		62	36
Qualifying shares :						
Douglas W. Wilson	1			1		
Wm. W. Roe	1			1		
A. A. McDowell	1			1		
C. A. Page	1					
G. V. Allen	1					
Walter F. Haas	1					
Frank P. Doherty				1		
Treasury Stock				7		
	806	5000	3500	11	5000	3500

1. All but qualifying shares of "Class A" preferred stock were retired in 1932 and 1933 pursuant to the stock contract.

The Legal Publishing Company was owned by C. A. Page and G. V. Allen who in 1930 took over that corporation's stock in Consolidated Printing & Publishing Co. Thereafter, in December 1930, they dissolved the Legal Publishing Company. Subsequently they have distributed part of their holdings to members of their respective families.

[39] The capital stock of the Daily Journal Company, the petitioner, was owned in the years and in the amounts shown in the schedule below :

<u>Name of Stockholder</u>	<u>Shares held on May 3, 1917¹</u>	<u>Shares held on July 1 1929²</u>	<u>Shares held on March 20 1933³</u>		<u>Shares held during 1936, 1937 and 1938</u>	
			<u>Pfd.</u>	<u>Com.</u>	<u>Pfd.</u>	<u>Com.</u>
Warren Wilson	5					
Wm. W. Roe	5	5*	15*	5*	15*	5*
Wm. W. Roe, Trustee ⁴	475					
Mrs. C. M. Wilson	5	5*				
Douglas W. Wilson	10	65	1050	350	1050	350
Walter F. Haas		5*	15*	5*	15*	5*
Cora Wilson Prewett		70				
Clara Wilson Tousley		70	210	70	210	70
Lois Wilson Kinney		70				
Florence Wilson McDowell		70	210	70	210	70
Grace Wilson McLean		70				
Irma Wilson Dorland		70				
	<u>500</u>	<u>500</u>	<u>1500</u>	<u>500</u>	<u>1500</u>	<u>500</u>

1—May 3, 1917, shortly after the death of Warren Wilson, Douglas W. Wilson was elected President of Daily Journal Company.

2—The consolidation in 1929 was effective as of July 1, 1929.

3—On March 20, 1933, Daily Journal Company capitalized \$150,000 of earned surplus and issued a preferred stock dividend of 1500 shares of 17% preferred stock.

4—Trustee for Warren Wilson, Deceased.

*—Qualifying Shares.

The agreement between the petitioner and the Legal Publishing Company, entered into on June 20, 1929, relative to the creation of the Consolidated, provided in part:

It is hereby further covenanted and agreed that the executive officers of said new corporation shall not charge or receive any salary for their services rendered to said corporation unless otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation.

* * * * *

[40] It is hereby further covenanted and agreed that each of the said contracting parties and the stockholders of said contracting parties so far as the same can be bound by this agreement, will use their best efforts and endeavors to further and promote the business of said new corporation.

During the taxable years 1936, 1937 and 1938 the assets of the petitioner consisted principally of capital stock of the Consolidated Printing & Publishing Company. Petitioner had some cash, accounts and notes receivable, and real estate, none of which required any considerable time or service of Wilson with respect to the management thereof, and reasonable compensation for which was \$2,000 per year, which is not controverted and was allowed as a deduction by the Commissioner in computing petitioner's net taxable income. Practically all the petitioner's income was received from the Consolidated Printing & Publishing Company in the form of dividends on the stock which the petitioner owned therein.

The petitioner in the taxable years owned no printing presses and did not actually print and publish any newspaper. The Los Angeles Daily Journal, however, was printed and published by the Consolidated for the Daily Journal Company.

Wilson, as contemplated by the agreements heretofore referred to and pursuant to instructions of the stockholders and directors of the petitioner, devoted practically all his time during the taxable years to the operation and management of the Daily Journal Company and the other papers constituting the Consolidated, the fair value of the services so rendered to the Consolidated being, as agreed by the parties hereto, not less than \$12,000 per an-

num, which amount was paid by petitioner to Wilson in each of the taxable years. No compensation was paid to Wilson by the Consolidated for his services in managing its affairs. [41]

After the incorporation and organization of the Consolidated, the offices of the Daily Journal and of its president, Wilson, and of the Consolidated, were in the same building and in the same room. The name, Consolidated Printing and Publishing Company, does not appear any place at the offices nor has the Consolidated ever had any letterheads or billheads. So far as the general public is concerned, the newspapers forming or constituting the Consolidated are still published as before the consolidation.

At no time during the taxable years did Wilson own any Consolidated stock, other than one qualifying share of Class A.

In computing petitioner's taxable net income for the taxable years, \$10,000 of the \$12,000 paid Wilson by petitioner each year was disallowed by the Commissioner.

During each of the years 1937 and 1938, the petitioner paid to its stockholders all dividends received from Consolidated, after deducting operating expenses, as evidenced by the earned surplus balances at the end of 1937 and 1938 of \$558.41 and \$504.53, respectively.

During the years 1937 and 1938 petitioner had gross incomes of \$40,851.75 and \$26,772.51, respectively, and after paying in each of said years \$12,000 as salary to Wilson and other operating expenses, the petitioner paid out in 1937 and 1938 dividends totaling \$29,000 and \$13,500, respectively.

The following facts have been stipulated and agreed upon:

The Long Beach Hotel Company, a Delaware corporation, was organized on April 22, 1929.

As of May 1, 1929, this corporation issued \$1,150,000.00 of "Breakers Hotel First Mortgage Fee 6-1/2% Sinking Fund Gold Bonds" (hereinafter referred to as "Bonds") secured, under a trust indenture, by the hotel properties comprising the Breakers Hotel in Long Beach, California.

[42] On May 24, 1929, petitioner purchased Breakers Hotel First Mortgage Fee 6-1/2% Sinking Fund Gold Bond No. M-1312, at a cost to petitioner of \$1,000.00. This Bond was one of the bonds heretofore referred to.

As of July 18, 1938, the date of a reorganization plan, to be hereinafter referred to, there was outstanding bonds in the principal amount of \$1,141,375.00.

On November 1, 1931, the interest payments due on the bonds were defaulted. On May 1, 1932, the sinking fund requirements with respect to the bonds were defaulted.

On November 17, 1931, the trustee under the bond indenture took possession of the property and operated it until November 15, 1933, when the hotel was closed. Subsequent to the closing of the hotel, trustee maintained the fixtures in good condition.

After default as above set forth a "First Mortgage Bondholder's Committee" (hereinafter referred to as "Committee") was organized to protect the interests of the holders of the bonds. The Committee drew up a Deposit Agreement covering the terms of

the deposit of the bonds with the Committee, which Deposit Agreement was dated October 26, 1931.

* * *

Among other things, the Deposit Agreement provided for the issuance of a "Certificate of Deposit" upon the deposit of a bond or bonds by a bondholder.

As of July 18, 1938, a Reorganization Plan (hereinafter referred to as "Plan") was submitted by the Committee to the bondholders. * * *

On August 18, 1938, and pursuant to the Plan, petitioner deposited the said Bond M-1312 with the Title Insurance and Trust Company in Los Angeles, a Sub-depositary under the said Deposit Agreement, and received in return therefor Certificate of Deposit No. 1086 * * *

Pursuant to the Plan as of October 5, 1938, there were on deposit with the Sub-depositary, Title Insurance and Trust Company, bonds in the principal amount of \$1,024,500.00. In addition, the Sub-depositary had received notices of dissent from the Plan with respect to bonds, in the principal amount of \$4,500.00.

Pursuant to the Plan, a California corporation, "200 East Ocean Boulevard Company" (hereinafter referred to as the "new corporation") was organized to buy the property of the old company at a Trustee's Sale.

[43] On October 5, 1938, and pursuant to the authority of the California Corporation Commissioner, the new corporation issued its capital stock in exchange for the bonds which had been deposited with the Sub-depositary, which bonds were transferred

and assigned to the new corporation by the Committee. * * * The trustee under the trust indenture securing the bonds sold the property at a public sale on October 5, 1938, to the new corporation. The new corporation applied the bonds, which it had received in exchange for its own stock, against the bid price. The stock of the new corporation was issued to the old bondholders in exchange for their Certificates of Deposits which they had previously received upon depositing the bonds with the Committee. Ten (10) shares of stock were issued with respect to each Certificate of Deposit representing bonds in the principal amount of \$1,000.00.

* * * * *

On November 16, 1938, petitioner surrendered the said Certificate of Deposit No. 1086, and received therefor Certificate No. 733, representing ten (10) shares of capital stock of the new corporation. The market price and fair market value of the capital stock of the new corporation on November 16, 1938 and on December 31, 1938, was \$5.00 per share.

* * * * *

On December 31, 1938, petitioner charged off its \$1,000.00 investment in Bond M-1312 as a bad debt loss, and deducted the same as bad debt loss on its 1938 income tax return. Respondent has disallowed this deduction in its entirety.

OPINION.

The record shows that the petitioner, Daily Journal Company, in the taxable years involved owned approximately two-thirds of the stock of the Consolidated Printing & Publishing Company. It further shows that the services which Douglas W. Wilson performed for and as the executive head of the Consolidated, during the taxable years involved, at the instance and under the instructions of the Daily Journal Company, pursuant to the understanding and agreement of the parties forming the Consolidated, were of the value of not less than \$12,000 in each of the taxable years. It is shown that each of [44] the newspapers forming the Consolidated and owning stock therein received dividends therefrom which resulted from Wilson's management and services. The first issue for our determination is: In computing petitioner's net income, what amount may be deducted for the services rendered as stated in each of the taxable years by the petitioner, as reasonable, ordinary and necessary business expense, or compensation to Wilson? That issue, when analyzed, resolves itself into the question: May the petitioner claim as a deduction \$12,000 paid by it to Wilson in each of the taxable years, for the services he in fact performed for Consolidated by direction of petitioner, who indirectly received benefit therefrom by reason of being a stockholder in Consolidated and receiving dividend distributions therefrom? In other words, may one corporation claim as a deduction, the cost to it and value of services rendered directly to another corporation, when the services performed only benefit the former indirectly in the way or manner above stated?

The evidence shows that Wilson was the president of two corporations, the Daily Journal Company and the Con-

solidated Printing & Publishing Company, and that the services he performed for each and the businesses of each were in some material respects different. The Daily Journal Company in the taxable years in issue did not itself print and publish the Los Angeles Daily Journal; in fact it owned no printing presses, and the record shows that in the conduct and operation of its affairs, distinct and separate from the management of the Consolidated Printing & Publishing Company, comparatively little time and attention of Wilson was demanded, required or rendered. For the services so rendered to the Daily Journal Company by Wilson in the taxable years, the respondent, in computing petitioner's taxable net income, allowed as a deduction in each of the taxable years the sum of \$2,000 and we find no evidence [45] in the record overthrowing the presumption of the correctness of the respondent's determination in that respect and the same is accordingly approved.

We are further of the opinion, find and hold that the time and services devoted by Wilson, as the president and general manager of the Consolidated, to its affairs in the taxable years were of the value of \$12,000 in each of said years as the parties hereto have agreed. The business of the Consolidated Printing & Publishing Company in part was to print and publish the newspapers composing the Consolidated or to have the same done, and to effect the same appropriated substantially all of the time and services of its president and general manager, Wilson. The record, however, does not, in our opinion, show that in the taxable years, 1936, 1937 and 1938, Consolidated was incapable of managing and conducting its own affairs through its board of directors.

The petitioner did not have complete domination and control of Consolidated; in fact, petitioner was the holder

of only approximately two-thirds of the Consolidated stock. With respect to the authorization of officers' salaries of Consolidated, the petitioner had practically no control, since said salaries, if any, required the unanimous affirmative vote of Consolidated's board of directors. Whether the expenditures or payments made by petitioner to Wilson for his services rendered directly to Consolidated to increase its profits or income, which resulted in the petitioner receiving larger dividends on the stock it held in Consolidated, may reasonably be considered ordinary and necessary expenses incurred by petitioner in carrying on its business, which was of the character heretofore indicated, is the question presented.

That the \$12,000 salary payment by petitioner to Wilson in each of the taxable years, in the circumstances shown, was not an ordinary expense of [46] petitioner in the carrying on of its business, in the usual sense and meaning of the statute, is virtually conceded by petitioner's counsel, who at the hearing herein, in part, stated: "With regard to the salary issue, I might add this is not the ordinary salary case by any manner or means. I know of no case on the books that is any where close to the issue that we have." We think that *W. M. Ritter Lumber Co.*, 3 B. T. A. 231 (272), and *Security First National Bank of Los Angeles, Executor*, 28 B. T. A. 289 (319), offer analogy to the present case. In the former we disallowed deduction, as ordinary and necessary expenses, of payments made by the petitioner for services rendered another corporation engaged in selling petitioner's products. We pointed out that the payees were not employees of the petitioner, which was under no legal obligation to pay them. The latter case involved payments made by the petitioner's decedent to an employee

of a corporation, in which petitioner's decedent was a stockholder. We held that the amounts were not deductible as ordinary and necessary business expense. See also *Thomas H. Martin* (1927), 7 B. T. A. 72; *affd.* (C.C.A. 8, 1938), 28 Fed. (2d) 748; *Welch v. Helvering*, (1933), 290 U. S. 111.

The circumstances and facts disclosed by the record, in our opinion—and we so hold and determine—show that the petitioner and the Consolidated are distinct and separate corporate entities and that they are such may not be disregarded or ignored. We are further of the opinion, hold and determine that the payment of \$12,000 to Wilson in each of the taxable years by petitioner as compensation or salary for services rendered directly to and for Consolidated may not be considered ordinary and necessary expenses of carrying on business by petitioner and deducted as such in computing petitioner's taxable net income. [47]

Under the circumstances here involved, we can not agree with petitioner's view that its business was that of operation and management of Consolidated. Consolidated was owned, through stock held in the usual manner, by the petitioner and others, and the income of each therefrom was merely through dividends paid. We think it clear that the petitioner rendered no such services for Consolidated as to justify deducting, as ordinary and necessary expense of trade or business, the expense incurred by petitioner. The payments made were "in the nature of an additional investment," as we said in *Pierre S. du Pont*, 37 B. T. A. 1198 (1276), where a stockholder made payments in order to benefit a corporation in which he was a stockholder. *Menihan v. Commissioner*, 79 Fed. (2d) 304; *certiorari denied*, 296 U. S. 651, is to the same

general effect. Obviously this is not an ordinary business expense. "There is nothing ordinary in the stimulus evoking it, and none in the response." *Welch v. Helvering*, *supra*. The payments inured to the benefit of the petitioner only indirectly, as a stockholder in Consolidated, and only in proportion to stockholdings, for they were, except as to amount of stock owned, equally beneficial to the others owning stock in Consolidated.

A clear statement of the law touching the setting aside or disregard of corporate entities and citation of numerous authorities bearing on the subject are given in *Inland Development Co. v. Commissioner*, 120 Fed. (2d) 986 (C.C.A. 10), decided in June 1941.

The petitioner, in our opinion, is not entitled to any dividends-paid credit in the computation of its tax liability since, even though the excess salary be considered as a dividend, clearly it is not "pro rata, equal in amount, and with no preference to any share of stock as compared with other [48] shares of the same class." Sections 27 (g) and 351 (b) (2) (C), Revenue Act of 1936, and sections 27 (h) and 405 (a), Revenue Act of 1938.

The third and last issue is: Is the petitioner entitled to a deduction—as a bad debt, as claimed on its return or as a loss arising from a transaction entered into for profit as asserted might be allowed by amendment to petition—upon the exchange in 1938 of a Breakers Hotel \$1,000 bond for ten shares of the capital stock of 200 East Ocean Boulevard Company.

The determination of this issue, in our opinion, does not depend on whether or not that transaction constituted or resulted in a reorganization, since the issue is covered by section 112 (b) (5) of the Revenue Act of 1938, and

there was, regardless of reorganization, a transfer of property solely in exchange for corporate stock, and immediately thereafter the transferors were in control of the corporation-transferee. Stock received was in proportion to interest formerly held. Therefore no gain or loss is recognizable. See Frederick L. Leckie, (1938), 37 B. T. A. 252, at page 257.

The petitioner, in our opinion, sustained no loss by reason of the exchange of a \$1,000 bond of the Breakers Hotel for the ten shares of the capital stock of 200 East Ocean Boulevard Company and the determination of the respondent with respect thereto is correct and accordingly approved.

Decision will be entered for the respondent.

ENTER:

[Stamped]: Entered May 11, 1942. [49]

[Title of Board of Tax Appeals and Cause.]

DECISION

Pursuant to the determination of the Board, as set forth in its Memorandum Findings of Fact and Opinion, entered May 11, 1942, it is

Ordered and Decided: That there are deficiencies in income taxes for the years 1936, 1937 and 1938 in the respective amounts of \$80.85, \$409.50 and \$500.70, and personal holding company surtaxes for the years 1937 and 1938 in the respective amounts of \$5,616.98 and \$9,638.38.

Enter:

(Signed) R. L. DISNEY
Member.

[Stamped]: Entered May 12, 1942.

[50]

[Written]: Sep - 9/22/41 - Los Angeles

[Title of Board of Tax Appeals and Cause.]

Deposition of Douglas W. Wilson, taken on behalf of Petitioner, at Suite 1118 Title Guarantee Building, 411 West Fifth Street, Los Angeles, California, at 9:30 o'clock a.m., Friday, September 5, 1941, before Marie O. Zellner, a Notary Public within and for the County of Los Angeles, and State of California, pursuant to the annexed stipulation.

Appearances of Counsel:

Dana Latham, Esq. and Ronald C. Roeschlaub, Esq.,
of the office of Latham & Watkins, appearing
on behalf of Petitioner.

Walter C. Wright, Esq., Certified Public Accountant,
also appearing on behalf of Petitioner.

E. A. Tonjes, Esq. (Honorable J. P. Wenchel, Chief
Counsel, Bureau of Internal Revenue), appearing
on behalf of the Commissioner of Internal
Revenue, Respondent.

[Stamped]: Received Sep. 15, 1941. U. S. Board
of Tax Appeals.

Filed Sep. 15, 1941. United States Board of Tax Appeals. Dkt. V. G. M.

Filed at hearing Sep. 21, 1941. U. S. Board of Tax Appeals.

[51]

CERTIFICATE ON RETURN

To the United States Board of Tax Appeals:

I, Marie G. Zellner, the person named in the foregoing stipulation to take deposition, hereby certify:

1. That I proceeded, on the 5th day of September, A. D. 1941, at the offices of Latham & Watkins, in the City of Los Angeles, State of California, at 9:30 o'clock a. m., under the said stipulation and in the presence of Messrs. Dana Latham, Ronald C. Roeschlaub, and Walter C. Wright, and Mr. E. A. Tonjes, the counsel of the respective parties, to take the following deposition, viz:

Douglas W. Wilson, a witness produced on behalf of the petitioner.

2. That the witness was examined under oath at such time, and that the testimony of the witness was taken stenographically and reduced to typewriting by me or under my direction.

3. That after the testimony of the witness had been reduced to writing, the transcript of that testimony was read and signed by the witness in my presence, and that the witness acknowledged before me that his testimony was in all respects truly and correctly transcribed.

4. That, after the signing of the deposition in my presence, no alterations or changes were made therein.

5. That I have no office connection or business employment with the petitioner or his attorneys. [52]

6. That, pursuant to the written requests of the parties, attached hereto, one copy of said deposition has been delivered to Alva C. Baird, Division Counsel, Pacific Division, Technical Staff, 1714 U. S. Post Office and Court House, Los Angeles, California, counsel for respondent; and one copy has been delivered to Mr. Dana Latham, Suite 1112 Title Guarantee Building, 411 West Fifth Street, Los Angeles, California, counsel for petitioner.

Marie G. Zellner,

Notary Public in and for the County
of Los Angeles, State of California.

Room 320 Wilcox Building,
206 South Spring Street,
Los Angeles, California.

My Commission Expires Dec. 27, 1944.

[53]

[Title of Board of Tax Appeals and Cause.]

STIPULATION TO TAKE DEPOSITION
OF DOUGLAS W. WILSON
IN BEHALF OF PETITIONER.

The above-named parties, through their respective counsel, hereby stipulate as follows:

(1) That issue has been joined in the within proceeding.

(2) The deposition of Douglas W. Wilson, whose business address is 121 North Broadway, Los Angeles, California, a witness in behalf of petitioner, may be taken at 9:30 A. M., Friday, September 5, 1941 at Suite 1112 Title Guarantee Building, 411 West Fifth Street, Los Angeles, California before Marie G. Zellner, a Notary Public in and for the County of Los Angeles, State of California, and an officer authorized to administer oaths. [54]

(3) That the deposition covered by this stipulation shall in all respects be governed by the applicable provisions of Rule 45 of the United States Board of Tax Appeals.

Dated this 5th day of September, 1941.

Dana Latham

Dana Latham

Counsel for Petitioner

J. P. Wenchel

F T H

Counsel for Respondent

[55]

[Title of Board of Tax Appeals and Cause.]

REQUEST FOR COPY OF DEPOSITION

It is hereby requested that one copy of the deposition of Douglas W. Wilson be delivered to Alva C. Baird, Division Counsel, Pacific Division, Technical Staff, 1714 U. S. Post Office and Court House, Los Angeles, California.

This request is made pursuant to section (j) of rule 45 of the Rules of Practice of the United States Board of Tax Appeals.

J. P. Wenchel

F T H

J. P. WENCHEL,

Chief Counsel,

Bureau of Internal Revenue.

Of Counsel:

Alva C. Baird,

Division Counsel.

Frank T. Horner,

E. A. Tonjes,

Special Attorneys,

Bureau of Internal Revenue.

[56]

Paul R. Watkins

Dana Latham

A. R. Kimbrough

Richard W. Lund

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LATHAM & WATKINS

Attorneys at Law

Suite 1112 Title Guarantee Building

Mutual 5271

Los Angeles

September 4, 1941

Marie G. Zellner,
 Notary Public in and for
 the County of Los Angeles,
 State of California
 206 South Spring Street
 Los Angeles, California

In Re: Daily Journal Company v. Commissioner
 of Internal Revenue, Docket #105054
 Dear Madam:

In accordance with the provisions of Rule 45, subdivision (j), of the United States Board of Tax Appeals, the undersigned, as counsel for the petitioner, respectfully requests that you deliver to him one copy of the deposition of Douglas W. Wilson in lieu of sending such copy to the Board of Tax Appeals as provided by said Rule 45 (j).

Respectfully,

Dana Latham

Counsel for Petitioner

[57]

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(Testimony of Douglas W. Wilson)

[58]

[Title of Board of Tax Appeals and Cause.]

Deposition of Douglas W. Wilson, taken on behalf of Petitioner, at Suite 1112 Title Guarantee Building, 411 West Fifth Street, Los Angeles, California, at 9:30 o'clock a.m., Friday, September 5, 1941, before Marie G. Zellner, a Notary Public within and for the County of Los Angeles and State of California, pursuant to the annexed stipulation.

Appearances of Counsel:

Dana Latham, Esq. and Ronald C. Roeschlaub, Esq. of the office of Latham & Watkins (Suite 1112 Title Guarantee Building, 411 West Fifth Street, Los Angeles, California) appearing on behalf of Petitioner.

Walter C. Wright, Esq., Certified Public Accountant, also appearing on behalf of Petitioner.

E. T. Tonjes, Esq., (Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the Commissioner of Internal Revenue, Respondent.

[59]

DOUGLAS W. WILSON,

called as a witness on behalf of the petitioner, being first duly sworn by the Notary, deposed and testified as follows:

Direct Examination

By Mr. Latham:

Q. Will you state your name, please?

A. Douglas W. Wilson.

(Testimony of Douglas W. Wilson)

Q. Your business and residence addresses?

A. Business address, 121 North Broadway; residence, 4758 Haskill Avenue, Encino, California.

Q. The Broadway address is Los Angeles?

A. Yes, that is right.

Q. Your age? A. Fifty-three.

Q. Your occupation?

A. President and general manager of the Consolidated Printing and Publishing Company and president and general manager of the Daily Journal Company.

Q. Those are both California corporations?

A. Yes.

Q. Are you also a director and stockholder of both corporations? A. Yes.

Q. How long have you been associated with the Daily Journal? [60]

A. More or less all my life; that is, off and on since 1906.

Mr. Latham: I might add for the record that hereafter in referring to the corporations I will refer to the Daily Journal Company as the Daily Journal and the Consolidated Printing and Publishing Company as Consolidated.

Q. By Mr. Latham: State, briefly, the history of the Daily Journal Company?

A. The Daily Journal Company—the company itself or the paper?

Q. Well, the business.

A. The paper was started in 1888 by a man named Charles Palm, and which at that time was about the size of two sheets of the present telephone directory. It was purchased in 1893 by my father.

(Testimony of Douglas W. Wilson)

Q. What was the name of your father?

A. Warren Wilson. In 1895 he incorporated the Daily Journal Company.

Q. That is the present company,—

A. That is the present company.

Q. —the Daily Journal Company, that you have just referred to? A. Yes.

Q. Proceed.

A. And it proceeded under his ownership up until the time of the merger of the company into the Consolidated [61] Printing and Publishing Company.

Q. What was the business of the Daily Journal?

A. Well, catering more or less to the legal profession, building and contracting trades, insurance companies, the title and insurance companies, and banks; in other words, all information of value to those different classes of business that was not covered by the metropolitan papers.

Q. It was the publication of a daily newspaper catering to those people? A. That is right.

Q. Who was the first president of the company? A. My father, Warren Wilson.

Q. How long did he continue as president?

A. Up to 1917, at the time of his death.

Q. He was in active charge during that entire period?

A. Yes.

Q. You first went to work for the company in 1906, I believe you stated?

A. In 1906 I took over the management of the circulation department.

Mr. Tonjes: This is still with reference to the Daily Journal?

Mr. Latham: That is right.

(Testimony of Douglas W. Wilson)

Q. By Mr. Latham: Did you subsequently become an officer of the Daily Journal Company? A. Yes.

[62]

Q. When did you first become an officer?

A. In 1917.

Mr. Latham: This is off the record.

(Discussion off the record.)

Q. By Mr. Latham: I show you what purports to be the minutes of a meeting of the board of directors of the Daily Journal Company, dated August 29, 1912. Can you identify those minutes? A. Yes.

Q. Those are the minutes of a meeting of the directors of that company held on the date specified?

A. That is correct.

Mr. Tonjes: What date was that?

Mr. Latham: August 29, 1912.

Q. By Mr. Latham: I read the following excerpt from those minutes:

“Resolved that Douglas Wilson be and he is hereby elected to the office of vice-president and assistant manager of the Daily Journal Company, to have the same powers and duties as the president and manager.”

Did you become vice-president and assistant manager, pursuant to those minutes, on that date?

A. Yes, I did.

Q. Then you were mistaken in stating that you first became an officer in 1917?

A. Yes. I was thinking of the office of president. [63]
I think that occurred in 1917.

Q. Did you subsequently become president of the Daily Journal Company? A. Yes.

(Testimony of Douglas W. Wilson)

Q. When was that?

A. I believe it was 1917, immediately after my father's death.

Q. Have you been president from that date to this?

A. Yes.

Q. How much of your time have you devoted to the affairs of that company, from 1912 to date?

A. All of my time.

Q. Have you received compensation, as president of the Daily Journal Company, from the date of your election in 1917 until the present?

A. Yes.

Q. At what annual rate?

A. \$12,000 a year.

Q. I show you what purports to be original minutes of a special meeting of the stockholders of the Daily Journal Company, held May 3, 1917, and ask you if you can identify that record.

(Handing document to witness.)

A. Yes.

Q. That represents the minutes of the meeting held on that date? [64]

A. That is correct.

Q. And the resolutions shown therein were duly adopted at said meeting?

A. That is correct.

Q. I would like the record to show that said minutes contain, among other things, the following:

"The meeting was called to order by Douglas Wilson, vice-president.

"On motion Douglas Wilson was nominated for president of the Daily Journal Company and William W. Roe for secretary of said company. Balloting was proceeded with and on counting the ballots it was determined that Douglas Wilson was elected president; William W. Roe, secretary."

(Testimony of Douglas W. Wilson)

Said minutes also show the following:

“On motion the salary of the president of the Daily Journal Company was reduced from \$24,000 per annum to \$12,000 per annum.”

So far as you know, has there been any subsequent corporate action taken by the Daily Journal Company with respect to your salary as president? A. None.

Q. So far as you know, that action has never been revoked, rescinded or otherwise altered? A. No.

Q. The salary which you drew in 1936, 1937 and 1938, as president, was pursuant to this original action? [65]

A. That is correct.

Q. I note from the minutes of the 1917 meeting just read, that the president's salary was reduced from \$24,000 to \$12,000. Does that mean that your father had been drawing \$24,000 a year as salary?

A. That is correct.

Q. Were your duties, when you became president in 1917, any different than those formerly performed by your father?

Mr. Tonjes: That is objected to as being immaterial and incompetent and having no bearing on the issues. I would just like to have the record show the objection.

Mr. Latham: Yes. You may answer.

The Witness: They were the same and greatly increased, due to the growth of the corporation and its holdings.

Q. By Mr. Latham: And due to the increased business done by the corporation? A. Yes.

Q. At the time you were elected president in 1917, how much stock of the Daily Journal Company did you own? A. 70 shares.

(Testimony of Douglas W. Wilson)

Q. In 1917?

A. No, I think it was a little after that. My father left the stock to my mother, and she divided it amongst seven children.

Q. Did you own any at the date of your election, if [66] you recall?

A. Qualifying shares, I believe.

Q. Otherwise, you had no actual ownership?

A. No.

Q. Since you became president of the Daily Journal Company in 1917, has the Commissioner of Internal Revenue, or any other governmental agency, ever questioned the reasonableness of the salary paid to you, except with respect to this present proceeding?

Mr. Tonjes: That question is objected to as being incompetent and immaterial, and having no bearing on the issues involved in this proceeding.

The Witness: No.

Q. By Mr. Latham: Between 1917 and 1929 did the business of the Daily Journal Company increase or decrease or remain constant?

A. From 1917 to 1929?

Q. Yes.

Mr. Tonjes: The question is objected to on the ground that the testimony of this witness is not the best evidence as to whether the business increased or decreased.

Mr. Latham: Under the circumstances, the question is withdrawn, with the understanding that specific schedules will be submitted later covering that point.

Q. By Mr. Latham: Throughout this period from 1917 to 1929 you acted as president of the Daily Journal Company [67] and devoted all of your time and energies to its affairs?

A. I did.

(Testimony of Douglas W. Wilson)

Q. You stated that you are also at the present time president and general manager of the Consolidated Printing and Publishing Company? A. Yes.

Mr. Tonjes: When was that company formed?

The Witness: In 1929.

Q. By Mr. Latham: State, briefly, the circumstances leading up to its formation.

A. Well, at that time there was serious competition—

Q. About what time do you refer to?

A. Well, immediately prior to 1929, for the previous four or five years, there was serious competition between The Los Angeles News, The California Independent, the Los Angeles Review and The Greater Los Angeles, all specializing in this one line of publication, and there was price cutting and battles from all different angles.

Q. You mean they were competing with the Daily Journal at that time, that is, in 1929? A. Yes.

Q. Approximately how much of this type of business in Los Angeles and vicinity did the Daily Journal have for itself? A. Of the total amount?

Q. Of the total business available? [68]

A. They had approximately two-thirds.

Q. Now, proceed with the history of the Consolidated Company.

A. We were first approached by Mr. Page of The Los Angeles News, who was our most serious competitor, on the formation of a company to take over the businesses of all of those different newspapers.

Q. Now, the News was published by what and by whom?

A. The Legal Publishing Company.

Q. That was a corporation?

A. That was a corporation.

(Testimony of Douglas W. Wilson)

Q. Owned by whom?

A. C. A. Page and George B. Allen.

Q. Proceed.

A. We discussed his proposal and finally agreed, that is, after meetings with the Daily Journal Company stockholders and directors we agreed to form the Consolidated Printing and Publishing Company and to put the assets and the good will and the tangible assets into the Consolidated Printing and Publishing Company.

Q. Now, the assets, good will, and so forth, of what were to go into the Consolidated?

A. Of The Los Angeles News, the Daily Journal Company and The Greater Los Angeles.

Q. How about the Independent?

A. That deal was made later on, after we made the deal [69] with the Legal Publishing Company.

Q. I show you a document which is entitled, "Petition of Consolidated Printing and Publishing Company to Issue and Sell Stock," addressed to the Corporation Commissioner of the State of California, and ask you if you have ever seen that document before?

A. Yes.

Q. Is that a true copy, so far as you know, of the original application as filed with the Corporation Commissioner?

A. Yes, it is.

Q. Where is the original, if you know?

A. It is either in our office or that is the original there, I don't know which.

Q. The original is probably with the Corporation Commissioner, isn't it?

A. I guess so. The attorneys handled that.

Mr. Latham: In order to show the plan under which the Consolidated Printing and Publishing Company was

(Testimony of Douglas W. Wilson)

organized, I offer at this time as Petitioner's Exhibit A said petition addressed to the Corporation Commissioner, omitting, however, for purposes of brevity the following exhibits attached to said petition, with the understanding that said omitted exhibits will be submitted, should counsel for respondent so request:

Form of stock certificate for Class A, Class B and common stock; [70]

Exhibit A, Articles of Incorporation;

Consolidated Printing and Publishing Company consolidated balance sheet;

Exhibit D and all pages entitled "Inventory"; with the further understanding that this document may be withdrawn and a photostatic copy of the portions offered submitted in lieu thereof.

Is that satisfactory, Mr. Tonjes?

Mr. Tonjes: With respect to the privilege of withdrawing the original of any portion of the document offered in evidence and submitting photostatic copies thereof, the respondent has no objection, but the respondent does object to the introduction of the document just offered on the ground that it is incompetent, irrelevant and immaterial.

(Thereupon the document referred to was marked "Petitioner's Exhibit No. A, 9-5-41," for identification, and the same is attached hereto and made a part hereof.)

Mr. Latham: Let the record show that so far as stock ownership of both the Daily Journal Company and the Consolidated Printing and Publishing Company is concerned, that schedules will be subsequently submitted showing this ownership.

(Testimony of Douglas W. Wilson)

Q. By Mr. Latham: Was the consolidation of the various companies engaged in the legal printing and publishing business in Los Angeles and vicinity in 1929 duly accomplished, as shown by the plan contained in the application to the [71] Corporation Commissioner?

A. Yes.

Q. And the tangible assets and subscription lists, and so forth, of the Daily Journal Company were duly transferred to the Consolidated Printing and Publishing Company?

A. Yes, their good will, their tangible assets, everything but their past accounts receivable and any cash or other holdings that were not needed by the paper for its functions.

Q. Who was the first president of Consolidated?

Mr. Tonjes: That is objected to as being immaterial, and has no probative value in connection with the issues involved in this proceeding.

The Witness: I was.

Q. By Mr. Latham: You have been president and general manager of Consolidated from the date of its organization in 1929 to the present?

A. That is correct.

Q. Do you recall how much of the stock of the Daily Journal Company you personally owned at the date of the consolidation in 1929?

A. I think 70 shares.

Q. Out of a total of how much, issued and outstanding?

A. Of the Daily Journal Company?

Q. Yes. A. 500 shares. [72]

(Testimony of Douglas W. Wilson)

Q. Who were the other officers of Consolidated upon its formation, other than yourself as president?

Mr. Tonjes: Objected to as being immaterial and irrelevant.

The Witness: Mr. Page, Mr. Haas, Mr. Roe and myself.

Q. By Mr. Latham: Those were men who had been connected with the constituent companies prior to the consolidation? A. Oh, yes.

Q. Approximately how much of the various classes of stock of Consolidated did the Daily Journal Company receive for its various assets, including good will?

A. Two-thirds.

Q. At the time of the consolidation, was there any agreement between the constituent papers with respect to their continuance or discontinuance after the consolidation?

A. They were all continued and still are, except they merged two of the small weeklies into one paper.

Mr. Tonjes: I move that the answer be stricken as not being responsive.

Q. By Mr. Latham: Was there any agreement or understanding at the time of the consolidation?

A. Yes. They were all to continue as long as they were successful financially.

Mr. Tonjes: Were any of these agreements in writing?

The Witness: I think they are in part of this agreement. [73] I am not sure.

Q. By Mr. Latham: But whether oral or in writing,— A. They were all making money.

(Testimony of Douglas W. Wilson)

Q. —the agreement was that they were all to be continued so long as they made money? A. Oh, yes.

Q. Turning to Petitioner's Exhibit A, the petition of the Consolidated Printing and Publishing Company addressed to the Corporation Commissioner, I show you Exhibit E attached to said petition, which purports to be a copy of a contract dated June 20, 1929, entered into between the Daily Journal Company and the Legal Publishing Company. You have seen that contract?

A. Yes.

Q. That contract was duly entered into between the parties named? A. Yes.

Q. You executed the contract, as president of the Daily Journal Company? A. I did.

Q. I notice that on page 5 the following paragraph appears:

"It is hereby further covenanted and agreed that the executive officers of said new corporation shall not charge or receive any salary for their services rendered to said corporation unless [74] otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation."

That was a part of that contract?

A. That is true.

Q. What did you mean by referring to the "new corporation"? A. The Consolidated.

Q. Why was that provision inserted in this contract between the Daily Journal Company and the Legal Publishing Company?

Mr. Tonjes: That is objected to as not being the best evidence. The agreement speaks for itself, and it is incompetent of the minority stockholders.

(Testimony of Douglas W. Wilson)

Q. By Mr. Latham: Minority stockholders of what?

A. Of the Consolidated Printing and Publishing Company.

Q. Why?

A. They felt that the stockholders of the company could regulate and pay higher salaries to the controlling interests in the company.

Q. Have you ever requested Consolidated to pay you a salary, as president or otherwise?

Mr. Tonjes: That is objected to as being immaterial.

Mr. Witness: No, I have not. [75]

Q. By Mr. Latham: From the date of the organization of Consolidated to the present, have you ever received anything directly from that company, by way of salary or otherwise? A. I never have.

Q. Prior to the consolidation and at the time this contract of June 20, 1929 was entered into, was it understood that you were to be president and general manager of the new company by all of the constituent parties?

A. Yes.

Q. Were these other parties also familiar with this provision with respect to salaries, so far as Consolidated was concerned? A. That is right.

Q. That is, I mean by the other concerns joining in the merger? A. Oh, yes.

Q. At the time of the consolidation, what was the understanding of the parties as to the duties which you were to perform as president and general manager of the Consolidated Company?

Mr. Tonjes: That is objected to as being immaterial and not the best evidence.

(Testimony of Douglas W. Wilson)

The Witness: My duties were to consist of operating all of the different papers owned by the Consolidated, and the management of the new company. [76]

Q. By Mr. Latham: In other words, it was understood that you were to be president and general manager in all that term implies? A. That is true.

Q. Was the plan of consolidation, as embodied in this contract of June 20, 1929 and as set forth in this application to the Corporation Commissioner' Petitioner's Exhibit A, duly submitted by you to the directors and stockholders of the Daily Journal Company? A. It was.

Q. And was it duly approved by them? A. Yes.

Q. Was their attention specifically called to the provision in the contract of June 20, 1929, prohibiting you and other officers from accepting any salary from Consolidated without the unanimous approval of the Consolidated's board of directors?

Mr. Tonjes: That is objected to on the ground it is premised on a conclusion and interpretation of the contract.

Mr. Latham: I will withdraw the question.

Q. By Mr. Latham: Was their attention specifically called to the provision in the contract of June 20, 1929, appearing on page 5, and heretofore read in the record, and which reads:

"It is hereby further covenanted and agreed that the executive officers of said new corporation [77] shall not charge or receive any salary for their services rendered to said corporation unless otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation."

A. Yes, it was.

(Testimony of Douglas W. Wilson)

Q. Was said provision discussed between you?

A. It was.

Q. And what was said with respect thereto, or what action was taken, if **any**?

A. By the general stockholders?

Q. Yes, and the directors.

Mr. Tonjes: The respondent objects on the ground that it is immaterial and incompetent.

The Witness: They stated that they felt that the Daily Journal Company should continue paying my salary, that the operation of the Daily Journal itself had only been moved from the company to a company under a different name, and the duties would be as great, if not greater, in taking over the responsibility of the other four papers, and that the Journal Company should continue paying my salary.

Q. By Mr. Latham: Did they give you any instructions with respect to your activities, as president of the Daily Journal Company? A. Yes.

Q. What were those instructions? [78]

A. To continue the operation of the Daily Journal and these other four papers.

Q. Was that to be in behalf of the Daily Journal Company? A. Yes.

Q. Immediately after the consolidation, the assets of the Daily Journal Company consisted of what? Just roughly. I don't mean in amount, but in general.

A. They had some cash, I think two pieces of real estate, and a small amount of stocks and bonds, and a few accounts receivable.

Q. And the various classes of stock of the Consolidated Company received upon the consolidation?

A. That is right.

(Testimony of Douglas W. Wilson)

Q. How much of your time, as president of the Daily Journal Company, did the management and control of these assets of the Daily Journal Company, other than the stock of Consolidated, require—

Mr. Tonjes: During what year, Mr. Latham?

Q. By Mr. Latham (Continuing) —from 1929 on, including the years 1936, 1937 and 1938?

Mr. Tonjes: The respondent objects to the question as it is framed, for the reason it covers years not before the Board and which have no bearing in this proceeding.

The Witness: You mean the assets that were left in the Daily Journal Company after the merger? [79]

Q. By Mr. Latham: Yes.

A. That belonged to the old company?

Q. That is right. A. Practically no time.

Q. During the years 1936, 1937 and 1938, then you devoted little or no time to the management of the assets of the Daily Journal Company, excluding its stock ownership in Consolidated?

A. That is right. That is all there was to the company.

Q. Now, from 1929 to the present, including the years 1936, 1937 and 1938, how much of your time did you devote to the affairs of the Daily Journal Company?

A. All of my time; more than I had previously, before the consolidation.

Mr. Tonjes: This is off the record.

(Discussion off the record.)

Q. By Mr. Latham: During these years, what was the principal asset and principal source of income of the Daily Journal Company?

A. The stock in the Consolidated Printing and Publishing Company.

(Testimony of Douglas W. Wilson)

Q. Which the company acquired upon the consolidation in 1929?

A. That is true. That is the only income they have had.

Q. In acting as president and general manager of [80] Consolidated, for whom were you acting?

A. The stockholders of the Daily Journal Company.

Q. And for the Daily Journal Company?

A. And for the Daily Journal Company.

Mr. Tonjes: I move that that be stricken on the ground it calls for a conclusion of the witness, and that it also calls for a conclusion of law.

Q. By Mr. Latham: Regardless of whether it calls for a conclusion of law or not, is your answer the same?

A. Yes.

Q. In acting as president and general manager of Consolidated, were you acting according to directions and instructions of the Daily Journal Company?

A. I was.

Q. After the consolidation, were meetings of the stockholders and directors of the Daily Journal Company held at regular intervals? A. Yes.

Q. What was the nature of the business generally transacted in these meetings?

A. Well, the discussion of the operation of the Consolidated, its policy, and any matters that might come up at the meetings, the Consolidated Printing and Publishing Company's meetings.

Q. Did you report regularly to the directors and stockholders of the Daily Journal as to the affairs and [81] progress of Consolidated? A. I did.

(Testimony of Douglas W. Wilson)

Q. Prior to the consolidation, where were the offices and plant of the Daily Journal located?

A. 121 North Broadway.

Q. Los Angeles? A. Yes.

Q. Your office, as president, was in the same location?

A. Yes, sir.

Q. After the consolidation, where were the offices and plant of the Consolidated located?

A. At the same location.

Q. And where was your office located?

A. At the same location.

Q. The same room? A. The same room.

Q. In the offices used by Consolidated and the Daily Journal Company at the location named, does the name "Consolidated Printing and Publishing Company" appear any place? A. No.

Q. Is that company listed in the Los Angeles telephone directory? A. No.

Q. I show you what appears to be a copy of a publication called, "The Los Angeles Daily Journal", dated August 26, [82] 1941. Was that paper the equivalent of the Daily Journal, as published by that company prior to the consolidation? A. You mean as to size?

Q. Well, as to size, name and general form?

A. Yes, in general form, the same thing.

Q. I notice that on page 4 the following appears, "Los Angeles Daily Journal. Published Daily Except Sunday by Daily Journal Company, Inc."

Why doesn't the name, Consolidated Printing and Publishing Company, appear in the space just mentioned?

A. It wouldn't mean anything to the publication. The

(Testimony of Douglas W. Wilson)

Journal is 50 some odd years old, and it is the name, Daily Journal, which is the good will of the paper.

Q. In other words, you do not want to lose any good will attaching to the old paper? A. No.

Mr. Latham: I offer as Petitioner's Exhibit B, the paper just referred to.

Mr. Tonjes: No objection.

(Thereupon the document referred to was marked "Petitioner's Exhibit B, 9-5-41," for identification, and the same is attached hereto and made a part hereof.)

Q. By Mr. Latham: I show you what purports to be a copy of "The Los Angeles News", dated September 4, 1941, and ask you if this is the equivalent of the paper published by [83] the Legal Publishing Company, prior to the consolidation in the year 1929.

(Handing document to witness.)

A. It is.

Q. This paper is now owned by the Consolidated?

A. By Consolidated.

Q. I notice on page 8 that the following appears, "The Los Angeles News. G. V. Allen, Publisher."

I take it, that the name of Consolidated is not employed for the same reason that it does not appear in "The Daily Journal"? A. That is correct.

Mr. Latham: I offer this copy of the paper as Petitioner's Exhibit C.

Mr. Tonjes: That is objected to as being incompetent and immaterial.

(Thereupon the document referred to was marked "Petitioner's Exhibit C, 9-5-41", for identification, and the same is attached hereto and made a part hereof.)

(Testimony of Douglas W. Wilson)

Q. By Mr. Latham: I show you what purports to be a copy of the "Independent Review," dated July 10, 1941, and ask you if that is published by the Consolidated Printing and Publishing Company?

(Handing document to witness.)

A. It is. [84]

Q. And this represents a consolidation of certain papers acquired, or, a merger of certain papers acquired during the consolidation in 1929?

A. That is right.

Mr. Latham: I will offer this as Petitioner's Exhibit D.

Mr. Tonjes: Objected to as being immaterial.

(Thereupon the document referred to was marked "Petitioner's Exhibit D, 9-5-41", for identification, and the same is attached hereto and made a part hereof.)

Q. By Mr. Latham: Mr. Wilson, were these papers, in the same form and in general in the same length, published by Consolidated during the years 1936, 1937 and 1938?

A. Yes, practically the same.

Q. Is the labor and effort required to published them now approximately the same as it was in 1936, 1937 and 1938?

A. Yes.

Q. Has the Consolidated now any letterhead or bill head?

A. None whatever.

Q. Has it ever had?

A. It never has had.

Q. We are to understand then that since the consolidation, including the years 1936, 1937 and 1938, these various papers have been operated as entirely separate departments?

A. That is right.

Mr. Latham: This is off the record. [85]

(Discussion off the record.)

(A short recess was taken.)

(Testimony of Douglas W. Wilson)

Q. By Mr. Latham: At directors' meetings of Consolidated, did any other director or directors of the Daily Journal sit in with you?

Mr. Tonjes: That is objected to as being immaterial.

The Witness: Yes.

Q. By Mr. Latham: So that through you and others the Daily Journal is constantly advised of the affairs and business of Consolidated?

A. Yes. There are always two or more directors of the Journal Company at Consolidated meetings.

Q. Compare your duties, as president of the Daily Journal Company, prior to the consolidation, with your duties during the years 1936, 1937 and 1938.

A. Well, I would say they had been multiplied considerably, due to the fact that we have an additional daily and three weeklies to take care of, in addition to the Daily Journal, which is a daily.

Q. Did any officer, other than yourself, draw any salary from the Daily Journal Company during the years, 1936, 1937 and 1938?

A. From the Daily Journal Company?

Q. Yes.

A. No. It paid no salary to anyone outside of myself.

Q. Have you an opinion as to what would have been [86] reasonable compensation during the years, 1936, 1937 and 1938, for a person of your experience and qualifications, who devoted all of his time, as president, to the affairs of the Consolidated Printing and Publishing Company, and had no connection with any other corporation? Just answer "yes" or "no." I am asking you whether you have an opinion.

Mr. Tonjes: That is objected to as being immaterial.

The Witness: I have.

(Testimony of Douglas W. Wilson)

Q. By Mr. Latham: In your opinion, what would constitute reasonable compensation in the years 1936, 1937 and 1938 for a person with your qualifications, who acted and was president of that corporation, Consolidated, for the years just mentioned?

Mr. Tonjes: Objected to as being immaterial.

The Witness: I would think a reasonable compensation for the management of an organization of that type would be from \$18,000 to \$20,000 a year.

Q. My Mr. Latham: That applies to the years, 1936, 1937 and 1938?

A. Yes, all during the life of Consolidated.

Q. Have you an opinion as to what would constitute reasonable compensation, for a man of your experience and qualifications, to perform the duties of president of a corporation, such as the Daily Journal Company, with the duties imposed upon and performed by you during the years 1936, 1937 and 1938? Have you any such opinion?

[87]

A. Just the Daily Journal alone?

Q. With all the duties that devolved upon the president of the Daily Journal. Have you an opinion?

A. Yes, I have.

Q. In your opinion, how much would be reasonable?

Mr. Tonjes: I object to the question as being incompetent and immaterial.

Mr. Latham: In your opinion, what would be such reasonable compensation?

A. \$12,000 to \$15,000 a year would be consistent.

Q. By Mr. Latham: Now, in considering what would constitute such reasonable compensation during these years, you have given consideration to the fact that one

(Testimony of Douglas W. Wilson)

or the principal duty of such officer was the management of Consolidated Printing and Publishing Company?

A. Yes.

Q. In your opinion, was the salary paid to and received by you, as president of the Daily Journal Company, during the years, 1936, 1937 and 1938, for services rendered by you to that company, reasonable or unreasonable?

A. Unreasonable.

Q. Your salary was unreasonable? A. Yes.

Q. In what respect? A. It was too low.

Q. What, in your judgment, should it have been? [88]

A. It should have been at least \$15,000 a year. You mean just the Journal itself?

Q. Yes. Then, in your opinion, the \$12,000 which you received during those years was, under no circumstances, excessive? A. Oh, no.

Q. Since the consolidation in 1929, what has been, in general, the dividend policy of the Daily Journal Company?

A. We pay out all dividends received from the Consolidated.

Q. After, of course, deducting expenses of the operation? A. Yes.

Q. And that policy has been consistently followed?

A. Yes, ever since the consolidation.

Mr. Latham: Now, may I have a moment?

Mr. Tonjes: Yes.

Mr. Latham: And may I step outside, for a moment, with my compatriots?

Mr. Tonjes: Certainly.

(A short recess, during which counsel for petitioner left the hearing room.)

Mr. Latham: You may cross examine.

(Testimony of Douglas W. Wilson)

Cross Examination

By Mr. Tonjes:

Q. Mr. Wilson, your attention was directed to the fact [89] that the Daily Journal, as it is published today, bears a notation that it is published by the Daily Journal Company? A. Yes.

Q. It is, as a matter of fact, published by the Consolidated Company, is it not? A. Yes, I guess so.

Q. The Daily Journal itself does not have any plant and it does not gather news and publish it and print it?

A. That is correct.

Q. Now, you stated also that, in your opinion, the value of the services performed by you for the Consolidated was approximately \$18,000 a year, did you not?

A. Yes.

Q. Did you receive any compensation from Consolidated? A. None whatever.

Q. Why not?

A. I have never asked for any, and the provision of that agreement there would not permit it; and, further, I was compensated by the Daily Journal Company.

Q. In other words, the Daily Journal Company paid you for services which you performed for Consolidated?

A. That is correct, and for the Daily Journal Company's stockholders.

Q. Just what services did you perform for the Daily Journal?

A. The management of the operation of the Daily Journal [90] and—

Q. Now, who—go ahead and finish your answer.

A. (Continuing) —and the management of the other four papers taken in the merger.

(Testimony of Douglas W. Wilson)

Q. Who published the Daily Journal?

A. After 1929?

Q. My questions, Mr. Wilson, will be directed entirely to the years, 1936, 1937 and 1938, unless I otherwise so specify.

A. Yes.

Q. Who published the Daily Journal during the years, 1936, 1937 and 1938?

A. The Consolidated Printing and Publishing Company.

Q. And it received the compensation for the fees paid for the paper?

A. They received all the income.

Q. They received all the income?

A. That is correct.

Q. Then whatever services you rendered in connection with publishing the Daily Journal flowed to the benefit of the Consolidated Company, did it not?

Mr. Latham: May I have that question?

(The question was read.)

The Witness: It did, and indirectly back to the Journal.

Q. By Mr. Tonjes: How would the Journal benefit by it? [91]

A. By receiving its pro rata of the dividends earned by the Consolidated.

Q. Then the primary purpose of your performing the services for the Consolidated Company was to increase the dividends which the Daily Journal Company might receive?

A. That is correct.

Q. You also stated that you performed certain services for the Consolidated Company, on behalf of the Daily Journal Company. Is that correct?

A. Yes.

(Testimony of Douglas W. Wilson)

Q. Now, did the Daily Journal Company receive any compensation for the services which you rendered to the Consolidated Company directly?

A. I don't believe I get your question.

Q. All right. Did the Daily Journal Company receive any compensation for the services which you rendered to the Consolidated Company?

We both appreciate, of course, that there would be an increase in dividends if the company, the Consolidated Company, made more profits by reason of your services, but did the Consolidated Company pay directly to the Daily Journal Company any money for your services?

A. Only through dividends.

Q. Only through dividends?

A. Only through dividends.

Q. That was the only benefit received by the company? [92] A. That is correct.

Q. Now, you also stated that at the meeting of the directors of the Consolidated Company, certain directors of the Daily Journal Company sat in those meetings?

A. Yes, sir.

Q. Did they sit in as directors of the Consolidated Company or merely because they were directors of the Daily Journal Company? A. Because they were directors of the Daily Journal Company.

Q. Were they also directors of the Consolidated Company? A. Two of them were.

Q. How many sat in the meetings of the Consolidated Company, who were not directors of the Consolidated Company? A. One.

Q. One? A. One is correct.

Q. Who was that? A. A. A. McDowell.

(Testimony of Douglas W. Wilson)

Q. Did he attend all meetings? A. Yes.

Q. He was quite regular in his attendance?

A. Oh, yes.

Q. And he was in there more as an observer than anything else?

A. Well, he and his wife owned stock in the Daily [93] Journal Company.

Q. He, of course, had no vote in the affairs of the Consolidated Company, did he?

A. No. I will take that back. He is a director of Consolidated. I am wrong about that.

Mr. Wright: He was not at that time?

Q. By Mr. Tonjes: Was he during the years 1936, 1937 and 1938? A. No, I don't think he was.

Q. He was not?

A. No. I am not positive on that.

Q. Then he would have no official voice in the management of the company at all, would he?

A. No. What I mean to imply there is he is not a director of the Daily Journal Company, but he is a director of the Consolidated Company and he represents his wife's holdings in the Daily Journal Company.

Mr. Wright: Off the record for a moment.

Mr. Tonjes: Yes.

(Discussion off the record.)

Q. By Mr. Tonjes: Maybe I can ask the question in this way:

Did anyone sit in the meetings of the board of directors of the Consolidated Company, who was not a member of the board of directors of the Consolidated Company, during the years 1936, 1937 and 1938? [94]

A. I don't believe they did.

(Testimony of Douglas W. Wilson)

Q. They were all directors of the Consolidated?

A. Yes.

Q. Now, the Consolidated published four papers, did it?

A. Yes.

Q. Approximately how much of the stock of Consolidated did the Daily Journal Company own?

A. Two-thirds.

Q. Two-thirds? A. Two-thirds.

Q. Did all four papers of Consolidated receive some benefit from the services which you rendered to the Consolidated?

A. Yes, they did.

Q. Now, did you devote all of your time to the affairs of the papers published by the Consolidated Company?

A. Yes, all of my time.

Q. Then you didn't devote any time directly to the affairs of the Daily Journal Company, outside of perhaps directors' meetings, and so forth?

A. And in representing their stock in the Consolidated.

Q. What do you mean by "representing their stock in the Consolidated"?

A. Well, through the management of Consolidated earning the stockholders of the Journal more revenue.

Q. Will you distinguish, if you can, the times you [95] appeared in meetings or performed other functions as a stockholder of the Daily Journal Company, purely as a stockholder, and the services which you rendered to the Consolidated Company to promote the interests of the Consolidated Company, as such?

I guess that is a little complicated. If you understand the question, answer it. Otherwise, skip it.

A. You mean if we ever held meetings of the board

(Testimony of Douglas W. Wilson)
of directors to discuss what we could do with Consolidated to increase the Journal's profits?

Q. Yes.

A. Yes, we have meetings of that kind right along.

Q. Now, how much time did you devote to that sort of thing?

A. Oh, practically—well, of course, we consider it more or less one and the same thing, because our whole interests are represented in the Consolidated; all the stock interests are in the Consolidated.

Q. It was, then, primarily to increase your dividends?

A. That is right.

Q. Do you own stock in any other companies?

A. No.

Q. Do you perform any services for any other companies without any compensation?

A. No, I have no connection with any other companies.

Q. Do you own any stock in any? [96]

A. Pardon me. Not outside of the Wilson Holding Company, which is a holding company of the Wilson real estate, which my father left, and which is inactive. That is, they just own the real estate.

Q. Then the entire organization which bears the name, Daily Journal Company, is really the business of Consolidated, is it not? That is to say, you say you have an office down here which has "Daily Journal Company" on it?

A. Yes.

Q. How large an office is it?

A. The whole plant?

Q. Well, the office, we will say, first.

A. Well, the office is about 40 by 73; that is for the clerical department, and then my office is just a small

(Testimony of Douglas W. Wilson)

room about half the size of this. There is no identification anywhere of Consolidated.

Q. How many employees do you have there in the office? A. In the whole—of Consolidated?

Q. Yes. A. Approximately 80 to 85.

Q. Now, are any of those employees employed directly by the Daily Journal Company?

A. No. I am the only employee of the Daily Journal Company.

Mr. Wright: I just want to interpose for correction: Hasn't the Daily Journal Company a part time bookkeeper? [97]

The Witness: Part time bookkeeper?

Mr. Wright: Yes, or a bookkeeper.

The Witness: I might be wrong about that.

Mr. Wright: Miss Bradford, I think it is.

The Witness: Is she paid by the old Daily Journal too? I think that has ceased, hasn't it?

Q. By Mr. Tonjes: Well, I want to direct your attention to the fact, Mr. Wilson, that the 1936 income tax return shows a deduction of compensation in the Officers' Schedule C of \$12,000.

Mr. Latham: What return is that?

Mr. Tonjes: The income tax return for 1936.

Mr. Latham: For the Daily Journal Company?

Mr. Tonjes: For the Daily Journal Company, yes.

Q. By Mr. Tonjes (Continuing) And that it shows salaries paid in the amount of \$189.01?

A. For a year?

Q. For a year. Can you tell me to whom those salaries were paid, and for what services?

A. I can't imagine, unless it is to an assistant bookkeeper for the Consolidated, who is making the entries to

(Testimony of Douglas W. Wilson)

some of these old accounts receivable for the old Daily Journal Company.

Q. The \$12,000 indicated on that return was paid to you?

A. That is correct. [98]

Q. To the best of your recollection, there were no substantial salaries paid, in addition to those shown on the 1936 return, for the years 1937 and 1938?

A. No, none whatever.

Q. Mr. Wilson, I think that you made reference in your direct testimony to the effect that the Consolidated Company instructed you to do certain things. Do you recall the nature of that testimony?

A. The Daily Journal Company instructed me. You mean at the time of the forming of the new Consolidated?

Q. No. During the years 1936, 1937 and 1938, did the Daily Journal, either its board of directors or stockholders, direct you to perform any services for Consolidated?

A. Oh, yes, from the time that Consolidated was incorporated right down to date they instruct me as to my operations.

Q. What do they instruct you to do?

A. Well, it is—

Q. Let's strike that and start over. Who instructs you?

A. The directors and stockholders of the Daily Journal Company.

Q. Do they give you any formal instructions?

A. Yes. We all discuss and agree upon a policy to pursue on certain matters that are coming up.

(Testimony of Douglas W. Wilson)

Q. Now, will you please state, as accurately as you can, what instructions you operated under during the years, [99] 1936, 1937 and 1938?

A. Yes. A big part of our volume is the City and County and State and Federal contracts, and those are yearly contracts. Those are always competitive bids, and sometimes we have advance information as to what those bids are going to be, and we govern our bid accordingly, as to whether we want to take it at a lower price, a higher price, or let it go. I might say that it demands a lot of work and time and attention and political contacts to wind these different contracts up, and those are all discussed in meetings of the Daily Journal Company, and our policy is all determined at that time, and then they instruct me as to what to do, or we come to a conclusion as to what to do.

Q. Those remarks relate to the publications published by the Consolidated Company?

A. Yes. We control the board of directors on the Consolidated. Therefore, our decision is final on any action taken.

Q. You were one of the directors on the board of directors of the Daily Journal Company?

A. Yes.

Mr. Latham: Still are?

The Witness: Still am.

Q. By Mr. Tonjes: And that action was taken in order that the dividend income of the Journal Company might be increased? [100]

A. That is right; continued or increased, if possible. In other words, we just consider the whole functioning is just the same today there as it has been since the Journal started. We don't even consider the Consolidated. The others are such a minority interest.

(Testimony of Douglas W. Wilson)

Q. Which is the largest of the several papers published by Consolidated? A. The Daily Journal.

Q. The Daily Journal? A. Is the largest, yes.

Q. Do they all make money?

A. Yes, every one of them has a profit.

Q. The actual work and services performed by you in connection with the holding of the assets of the Daily Journal Company and the management thereof did not consume a great deal of your time, did it?

A. The assets of the old Journal?

Q. Of the Daily Journal Company, which it owned, during the years 1936, 1937 and 1938?

A. Other than the stock in the Consolidated?

Q. I mean all of the assets.

A. Oh, yes. It consumed all my time, including the stock of the Consolidated. That is our sole interest and practically the only asset we have is our stock in the Consolidated.

Q. All you have to do is to hold the stock, don't you? [101]

A. If you didn't manage the Consolidated properly, the Journal wouldn't have anything.

Q. But the fact is you weren't required to do that, were you?

A. Oh, definitely, by the stockholders of the Daily Journal Company. That is our sole interest. We have no other interest.

Q. Suppose you just sat by and collected the dividends, what would happen?

A. I don't think there would be any dividends, if we just sat by.

(Testimony of Douglas W. Wilson)

Q. But you could do it, if you just so chose?

A. I don't see how we could collect the dividends. I don't believe there would be any.

Q. The actual legal imposition of duties upon you was merely to hold the assets; isn't that correct?

A. No.

Mr. Latham: Just a minute. Will you read the question? I believe he has answered that a number of times, Mr. Tonjes.

Will you read the question?

(The question and answer were read.)

Mr. Latham: Oh, I have no objection.

Q. By Mr. Tonjes: Was the answer "no"?

A. Yes.

Q. What else did you have to do?

A. To continue making a profit with those assets by [102] managing the Consolidated for the Daily Journal stockholders. That is the only source of income they have, and if not properly managed, would not be worth anything, and being a specialized business, I don't believe you could save those assets if they were mismanaged.

Q. Now, the \$12,000 salary which you received during the years, 1936, 1937 and 1938, was authorized by the board of directors in 1917? A. Yes.

Q. In 1917 was the Daily Journal Company operating a newspaper? A. Yes.

Q. And the corporation was then engaged in active business? A. Yes, the same as now.

Mr. Latham: Did you get that last?

The Reporter: Yes.

(Testimony of Douglas W. Wilson)

Q. By Mr. Tonjes: It published a newspaper?

A. The same as now. It continued the publication of that same newspaper.

Q. A moment ago, Mr. Wilson, you stated that the Consolidated published the Daily Journal now?

A. Yes.

Q. (Continuing)—all during the years, 1936, 1937 and 1938, and now you say that the Daily Journal Company is doing the same or is an active company now, or was in the years [103] 1936, 1937 and 1938 as it was in 1917.

A. We consider it as such, only our stock is just held through the Consolidated instead of directly by the Daily Journal Company.

Q. But the Daily Journal Company, as such, prints and publishes no newspaper, does it?

A. It doesn't own the newspaper in its own corporate name, but it owns it through the same Daily Journal stock through the Consolidated.

Q. Under your understanding of the term, you wouldn't call the Daily Journal Company an operating company, would you? A. I do, yes.

Q. What does it operate?

A. It operates the Consolidated Printing and Publishing Company, which is its sole interest.

Q. What does the Consolidated Printing and Publishing Company operate then?

A. Well, I would say the Consolidated Printing and Publishing Company is operated through the Daily Journal Company.

Q. The Daily Journal Company does not own any printing presses, does it?

(Testimony of Douglas W. Wilson)

A. No. They are just held by the Consolidated. It would have been better maybe if they had just made a lease of the paper to the Consolidated; I don't know. [104]

Q. I think that might be true.

A. It might have been at that. I don't know.

Q. Then, as a general proposition, you would say that the services for which you receive the \$12,000 a year from the Daily Journal Company are in connection with the operation of the newspapers published by the Consolidated Company? A. That is correct.

Q. And it is deemed to be good business, because it will increase the dividend income of the Daily Journal Company? A. That is correct.

Mr. Tonjes: I think that is all.

Mr. Latham: I have just one or two more questions.

Redirect Examination

By Mr. Latham:

Q. Mr. Wilson, I assume that the purpose or reason for the consolidation in 1929 was to increase the income of the Daily Journal Company?

A. That is correct, and to eliminate a lot of unpleasant competition in connection with it. There was price cutting.

Q. And were both those purposes accomplished?

A. Yes, definitely. That income was increased greatly.

Q. Was it understood at the time of the consolidation, and an inducement to the consolidation on the part of all [105] parties, that you would act as president of the Consolidated Company?

A. Yes, that was understood. It was understood that the Journal management would continue as the management of the Consolidated.

(Testimony of Douglas W. Wilson)

Q. Did the other constituent companies want the Journal management to continue? A. Yes, they did.

Q. Would you have deemed it a breach of faith had you failed to continue as such, as head of the Consolidated Company during the years in question?

A. Yes, I would, to both; to all stockholders of the Daily Journal Company and the Consolidated.

Q. In other words, I assume that the consolidation could not have been effected without the understanding that you would continue as president of the Consolidated Company throughout your remaining business career?

A. That is correct.

Q. And that understanding prevailed throughout the years, 1936, 1937 and 1938?

A. Yes.

Mr. Latham: May I step outside with my associates again?

Mr. Tonjes: Certainly.

(A short recess, during which counsel for the petitioner left the hearing room.)

Mr. Latham: We have nothing further. [106]

Mr. Tonjes: That is all.

Douglas W. Wilson.

Subscribed and sworn to before me this 10th day of September, 1941.

Marie G. Zellner

Notary Public in and for the County
of Los Angeles, State of California.

My Commission Expires Dec. 27, 1944.

[107]

105,054 Petn's Exhibit No. A Date 4/5/41 Marie
G. Zellner, Notary Public.

PETITION OF
“CONSOLIDATED PRINTING AND PUBLISHING
COMPANY”

TO ISSUE AND SELL STOCK.

TO THE HONORABLE, THE CORPORATION
COMMISSIONER OF THE STATE OF CALI-
FORNIA:

Comes now “Consolidated Printing and Publishing Company, a corporation, duly incorporated under the laws of the State of California, and respectfully shows:

That your petitioner filed its Articles of Incorporation in the office of the Secretary of State of the State of California, on the 29th day of July, 1929, and a duly certified copy thereof in the office of the County Clerk of the County of Los Angeles, State of California on the 31st day of July, 1929.

That a true copy of said Articles of Incorporation is hereto attached, marked “Exhibit A”, is hereby referred to and made a part hereof.

That on the 29th day of July, 1929, said Secretary of State issued to your petitioner a certificate of the incorporation of this petitioner in manner and form provided by law. That this petitioner at the time of filing of the said Articles in the office of the said Secretary of State paid all fees of said Secretary of State by said Secretary of State demanded.

That on the 2nd day of August, 1929, the incorporators of this corporation filed a written consent to the holding of the “First Meeting of the Organizers and Subscribers of Stock” of said corporation, and said meeting was thereupon duly held. That the proceedings were had and taken as shown by the minutes [108] of said meeting.

That a true copy of said Written Consent and Minutes of said meeting is hereto attached, is marked "Exhibit B" and is made a part hereof. That thereafter, to-wit: at 2:15 o'clock, P.M. of said day, the first meeting of directors of this corporation was held upon the written consent of the several directors succeeding the directors named in the By-laws, the directors named in the By-laws having resigned and their successors having been elected and the proceedings were had as shown in the minutes of said meeting, a copy of which said Consent and Minutes is hereto attached and marked "Exhibit C".

That a copy of the By-laws so adopted by said stockholders and directors and signed by said incorporators and stockholders is hereto attached, is marked "Exhibit D" and made a part hereof. That at said meeting so held at 2:15 o'clock P.M. of said 2nd day of August, 1929 of which a copy is hereto attached, marked "Exhibit C", the following resolution was adopted:

"RESOLVED, that a petition or application be made on behalf of this Corporation to the Corporation Commissioner of the State of California for leave to issue to The Daily Journal Company, a corporation, duly incorporated under the laws of the State of California, in consideration of the transfer and conveyance by the said The Daily Journal Company to the Consolidated Printing and Publishing Company of certain tangible assets and properties of the said The Daily Journal Company, particularly described in an inventory filed with the Secretary of said Consolidated Printing and Publishing Company, shares of the "Class A" preferred stock of said Consolidated Printing and Publishing Company; also to issue to Legal Publishing Company in

consideration of the transfer and conveyance to said Consolidated Printing and Publishing Company of certain tangible assets described in an inventory filed with the Secretary of said Consolidated Printing and Publishing Company shares of the "Class A" preferred stock [109] of said Consolidated Printing and Publishing Company; also to issue to said The Daily Journal Company in consideration of the transfer, assignment and conveyance by said The Daily Journal Company to said Consolidated Printing and Publishing Company of the good will, business, franchises, subscription lists, advertising lists and other properties mentioned and referred to in that certain contract dated the 20th day of June, 1929, made and entered into by and between The Daily Journal Company, a corporation, as party of the first part, and Legal Publishing Company, a corporation, as party of the second part, 3,750 shares of the "Class B" preferred stock of said Consolidated Printing and Publishing Company; also to issue to Legal Publishing Company in consideration of the transfer, assignment and conveyance by said Legal Publishing Company of the good will, business franchises, subscription lists and other assets to be transferred to said Consolidated Printing and Publishing Company as recited in that certain contract so dated the 20th day of June, 1929, made and entered into between The Daily Journal Company, a corporation, as party of the first part, and Legal Publishing Company, a corporation, as party of the second part, 1250 shares of the said "Class B" preferred stock of said Consolidated Printing and Publishing Company; also in consideration of the said transfer of said business, good will, and assets hereinabove mentioned by said

The Daily Journal Company, to issue to said The Daily Journal Company 2625 shares of the "Common" stock of said Consolidated Printing and Publishing Company; also to issue to said Legal Publishing Company in consideration of the transfer, assignment and conveyance of said business, good will and assets hereinabove recited to be conveyed to said Consolidated Printing and Publishing Company 875 shares of the "Common" stock of said Consolidated Printing and Publishing Company. That of the said stock so to be issued to said The Daily Journal Company, said corporation, as aforesaid, to be transferred to Dan W. Green, Marie McManus, Katheryn G. Lawson and Elmer G. Riggins in consideration of the transfer and conveyance by them to said Consolidated Printing and Publishing Company of all of the interests held by said persons in a certain newspaper and its assets, printed and published at Los Angeles, California, known and designated as "California Independent", 210.9375 shares of said "Class B" preferred stock and 122.325 shares of said "Common" stock, and out of said stock to be issued to said Legal Publishing Company as aforesaid, there is to be transferred and issued to said persons, to-wit: Dan W. Green, Marie McManus, Katheryn G. Lawson and Elmer G. Riggins 70.3125 shares of [110] "Class B" preferred stock and 40.775 shares of "Common" stock. That likewise out of the said stock so to be issued to said The Daily Journal Company, there is to be issued to Dan W. Green in consideration of the sale, assignment and transfer by the said Dan W. Green to said Consolidated Printing and Publishing Company of the one-half ($1/2$) interest of the said Dan W. Green in and to a certain

newspaper and its plant known and designated as "Los Angeles Review" printed and published at the City of Los Angeles, County of Los Angeles, State of California, 281.25 shares of "Class B" preferred stock and 163.275 shares of the "Common" stock and by said Legal Publishing Company 93.75 shares of said "Class B" preferred stock and 54.425 shares of said "Common" stock.

BE IT FURTHER RESOLVED, that said Corporation Commissioner be requested to permit the sale of all of the remainder of the "Class A" preferred stock at its par value, without the payment of any brokerage, the moneys derived from such sale to be placed in the treasury of this Company to be used in the same manner as other moneys used in the business of and for the development of this Company, and

BE IT FURTHER RESOLVED, that the President and Secretary and Directors of this Company be authorized to take such steps and to execute such documents in the name of this Company as may be necessary or convenient to obtain from the Corporation Commissioner the permit hereinabove referred to."

That the petitioner has not heretofore issued any stock to anyone.

That this petitioner has not issued any securities or evidence of debt and has not incurred any debt. That this petitioner is organized for the purpose of consolidating certain printing and publishing establishments known and designated and heretofore and now doing business at the City of Los Angeles, County of Los Angeles, State of California, under the following names and designations,

to-wit: First: "The Los Angeles Daily Journal" operated and conducted by The Daily Journal [111] Company, a corporation; "The Los Angeles News", printed and published by Legal Publishing Company, a corporation, at the City of Los Angeles, County of Los Angeles, State of California; "California Independent", printed and published by a co-partnership composed of Dan W. Green owning a one-fourth interest, Marie McManus owning a one-sixth interest, Katheryn G. Lawson owning a one-sixth interest, Elmer G. Riggins owning a one-sixth interest and Legal Publishing Company, a corporation, owning a one-fourth interest; also a one-half interest in a certain newspaper and its plant known and designated as "Los Angeles Review," printed and published at the City of Los Angeles, County of Los Angeles, State of California, by Dan W. Green and George Reuter, the interest of said Dan Green in said newspaper being that to be acquired by and consolidated with said other newspapers hereinabove mentioned in the one ownership, to-wit: title to be vested in said Consolidated Printing and Publishing Company.

That on the 20th day of June, 1929, said The Daily Journal Company, a corporation, as party of the first part, made and entered into a contract with said Legal Publishing Company as party of the second part, for the consolidation of the business of said The Daily Journal Company and said The Legal Publishing Company in the printing and publication by said The Daily Journal Company of the "Los Angeles Daily Journal" and the printing and publication by said The Legal Publishing Company of said "The Los Angeles News", and in that behalf for the organization of a new corporation to be known and designated as "Consolidated Printing and

Publishing Company." That the said contract was in writing and executed pursuant [112] to resolutions adopted by the Boards of Directors of each of the said corporations by the said corporations; that a copy of the form of said contract so entered into is hereto attached, is marked Exhibit "E", is hereby made a part hereof and referred to. That thereafter negotiations were entered into between said Daily Journal Company and said Legal Publishing Company with Dan W. Green, Marie McManus, Katheryn G. Lawson and Elmer G. Riggins for the consolidation of the outstanding three-fourth interest held by said persons in and to that certain newspaper printed and published at the City of Los Angeles, designated as "California Independent", the other outstanding one-fourth interest being then held by said Legal Publishing Company and being included within the purview of the said contract, a copy of which is hereto attached, marked "Exhibit B." That pursuant to the said negotiations so had on the 28th day of June, 1929, said The Daily Journal Company, a corporation, and Legal Publishing Company, a corporation, as parties of the first part made and entered into a contract in writing with Dan W. Green owning a one-fourth interest, Elmer G. Riggins owning a one-sixth interest, Marie McManus owning a one-sixth interest and Katheryn G. Lawson owning a one-sixth interest for the acquisition by said Consolidated Printing and Publishing Company under the terms in said contract stated, for the said three-fourth interest in the ownership of said California Independent, a copy of the form of which said contract so entered into is hereto attached, is marked "Exhibit F", is hereby referred to and made a part hereof.

That thereafter negotiations were entered into with one Dan W. Green for the acquisition by said The Daily Jour-

nal Company and said Legal Publishing Company for said Consolidated Print- [113] ing and Publishing Company of the interest of Dan W. Green in and to the business and printing establishment of that certain periodical or newspaper printed and published at the City of Los Angeles, County of Los Angeles, State of California, to-wit: a one-half interest therein, the other half interest therein being owned by one George P. Reuter. That the said negotiations culminated in a written contract dated the 29th day of June, 1929, made and entered into between The Daily Journal Company, a corporation and Legal Publishing Company, a corporation, as parties of the first part, and Dan W. Green as party of the second part, a copy of which said contract is hereto attached, is marked "Exhibit G", is hereby referred to and made a part hereof.

That on the 3rd day of July, 1929 for the considerations therein mentioned, the said George P. Reuter, the associate of said Dan W. Green in said Los Angeles Review, did make and enter into a contract in writing with The Daily Journal Company, a corporation, Legal Publishing Company, a corporation, California Independent, a co-partnership, and Dan W. Green, the form of which said contract is hereto attached, is marked "Exhibit H" and is hereby referred to.

That as will appear from the said several contracts, copies of the form of which are hereto attached, to-wit: Exhibits "E", "F" and "G", certain of the stock of said corporation, to-wit: of the "Class A" preferred stock is to be, with the consent of the Corporation Commissioner, issued to said The Daily Journal Company at par in payment of physical tangible assets to be conveyed by the component companies and individuals to said Consolidated

Printing and Publishing Company, all as [114] appears from the said several contracts hereto attached and marked Exhibits "E," "F", and "G", and the amount of "Class B" and "Common" stock to be issued to the several component companies with the consent of the Corporation Commissioner were predicated upon the earning capacities and earnings of the several component companies and individuals as experienced during the last three or four years so that in the distribution of the earnings to be made in the future by the Consolidated Printing and Publishing Company, the component companies and individuals entering into said consolidation would receive rateably the same proportions of earnings as theretofore had and enjoyed by the said several component companies and individuals. The maximum of 20% on said "Class B" preferred stock was predicated upon the probability of the earnings in the near future, reaching that figure, and the "Common" stock was designed to provide for a surplus earnings if any, over and above the 7% on the "Class A" preferred and the 20% on the "Class B" preferred. The 7% on the "Class A" preferred was to meet simply the legal rate of interest that the Consolidated Printing and Publishing Company would have to pay to a lender of money if he purchased the tangible assets for cash.

It will be observed from the said several contracts that provision was made for paying certain earnings to W. W. Roe as Trustee pending the action of the Corporation Commissioner upon this application to form a nucleus for working capital and is further intended with the consent of the Corporation Commissioner, from time to time to sell such of the "Class A" preferred stock to the component companies and individuals at par as needed, the said proceeds of such sale to be used as working capital

in the conduct of the business of said Con- [115] solidated Printing and Publishing Company. The latter applies to such of the "Class A" preferred stock as is not issued to the component companies and individuals for the tangible assets conveyed by them to this corporation.

It is further contemplated to retain at least for the time being, the corporate existence of said The Daily Journal Company and said Legal Publishing Company as well as the identity of said co-partnership composing said California Independent for business reasons and to facilitate the distribution of stock issued to said component companies and partnership for which reason the application is made for leave to issue stock to the said two corporations and to the said individuals owning the said three-fourths interest in the said California Independent and to the said Dan W. Green for his one-half interest in the said Los Angeles Review. Ultimately said Consolidated Printing and Publishing Company will become the sole operative company but its status at first will be more or less that of a holding company in perfecting such consolidation.

All of the said publications mentioned in the said contracts are publishers of legal notices and advertising and were heretofore more or less competitors which militated quite strongly against their earnings and it is designed to over-come such competition in a very limited field.

For the further guidance of the Commissioner, inventories of the tangible assets to be transferred and conveyed to the Consolidated Printing and Publishing Company by the component companies and individuals are hereto attached and appropriately designated. Likewise, trial balances showing the condition of the business for the periods covered in the [116] past of said component com-

panies and individuals are hereto attached and properly designated.

That your petitioner offers to furnish such other data within its possession or under its control or which can be furnished by its said component companies and individuals relative to the subject matter of this application as the Commissioner may desire. An inspection of the books and papers of the said component companies by a representative of the Commissioner is hereby also tendered.

WHEREFORE, your petitioner prays for a permit authorizing said Consolidated Printing and Publishing Company, first: to issue to said The Daily Journal Company 440.6228 shares of "Class A" preferred stock in consideration of the transfer and conveyance to said Consolidated Printing and Publishing Company of the tangible assets covered by that certain inventory of The Daily Journal Company hereto attached, at par; Secondly: 3,257.8125 shares of the "Class B" preferred stock, and 2,339.40 shares of the "Common" stock of said Consolidated Printing and Publishing Company in consideration of the conveyance and transfer to said Consolidated Printing and Publishing Company of the business, good will, subscription lists, contracts and contractual rights and other intangible property of said The Daily Journal Company; Third: to issue to Legal Publishing Company 83.3955 shares of said "Class A" preferred stock in consideration of the transfer and conveyance to said Consolidated Printing and Publishing Company of the tangible assets described in the inventory of said Legal Publishing Company hereto attached, at par; Fourth: to issue to the Legal Publishing Company 1085.9375 shares of the "Class [117] B" preferred stock and 779.80 shares of the "Common"

stock of said Consolidated Printing and Publishing Company in consideration of the transfer and conveyance to said Consolidated Printing and Publishing Company of the business, good will, subscription lists, contracts, contractual rights and other intangible assets of said Legal Publishing Company.

(Note: It will be observed that the number of shares of the "Class B" preferred stock and "Common" stock to be issued to said The Daily Journal Company and said Legal Publishing Company have been reduced from the number of shares mentioned in said contract, a copy of which is hereto attached and marked "Exhibit E" by the number of shares which each of said companies were to transfer under said contract, "Exhibit F", to Dan W. Green, Elmer G. Riggins, Marie McManus and Katheryn G. Lawson, and the number of shares each of said companies were to transfer under said contract, a copy of which is hereto attached and marked "Exhibit G", to Dan W. Green for his one-half interest in said Los Angeles Review.)

Fifth: To issue to Dan W. Green, Elmer G. Riggins, Marie McManus and Katheryn G. Lawson collectively 281.25 shares of said "Class B" preferred stock and 163.10 shares of "Common" stock, pursuant to the terms of said contract, copy of which is hereto attached, marked Exhibit "F", in consideration of the conveyance by them of their three-fourth interest in and to said California Independent, said newspaper, the other one-fourth interest having heretofore been and being owned by said Legal Publishing Company, and which said other one-fourth interest is to be conveyed to said Consolidated Printing and Publishing Company as a part of the consideration for the

issuance to said Legal Publishing Company of the "Class B" preferred stock and the "Common" stock hereinabove mentioned. Sixth: To issue to Dan W. Green pursuant to the terms of that certain contract, a copy of which is hereto attached, marked Exhibit "G", 375 shares of said "Class B" preferred stock and [118] 217.70 shares of the "Common" stock, in consideration of the conveyance by said Dan W. Green of his one-half interest in and to the business and assets of said Los Angeles Review, and for such further order in the premises as to the Honorable Commissioner may seem meet.

CONSOLIDATED PRINTING AND PUBLISHING
COMPANY, A Corporation,

By:
ITS PRESIDENT.

ATTEST:

.....
ITS SECRETARY.

WE hereby join in the foregoing Petition.

.....
.....
.....
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.....
.....
.....

Directors of
CONSOLIDATED PRINTING AND PUBLISH-
ING COMPANY.

[119]

STATE OF CALIFORNIA)
) SS.
 COUNTY OF LOS ANGELES)

DOUGLAS W. WILSON and DAN W. GREEN, President and Secretary respectively of "CONSOLIDATED PRINTING AND PUBLISHING COMPANY", a corporation, each for himself deposes and says: That said Douglas W. Wilson is the President of and said Dan W. Green is the Secretary of said "Consolidated Printing and Publishing Company", said corporation; that they and each of them have read the foregoing Petition and the Exhibits thereto attached and know the contents thereof; that the same is true and are true of their own knowledge; that the various exhibits thereto attached correctly set forth the various proceedings had at the time they were had and in the manner in which they were had.

SUBSCRIBED and SWORN to before me this
 day of SEPTEMBER, 1929.

 NOTARY PUBLIC in and for the County
 of Los Angeles, State of California.

[120]

“EXHIBIT B”

MINUTES OF FIRST MEETING OF ORGANIZERS
AND SUBSCRIBERS OF STOCK OF
“CONSOLIDATED PRINTING AND PUBLISHING
COMPANY”

held at Los Angeles, California, on the 2nd day of August, 1929 at the hour of 2:00 o'clock P. M. of said day, pursuant to the following consent and waiver of notice, to-wit:

We, the undersigned, being all of the organizers and subscribers to stock of “Consolidated Printing and Publishing Company” hereby give our written consent to the holding of the first meeting of the organizers and subscribers to stock of said Company at Suite 718 Citizens National Bank Building, in the City of Los Angeles, County of Los Angeles, State of California, on the 2nd day of August, 1929, at the hour of 2:00 P. M. of said day for the purpose of accepting and rectifying the Articles of Incorporation filed by the organizers, rectifying the appointment of the directors named therein, adopting By-Laws, accepting resignations of directors, filling vacancies on the board of directors, and for such other business as may come before the said meeting.

Dated the 2nd day of August, 1929.

NAME

NUMBER OF SHARES
SUBSCRIBED BY

K. G. LAWSON	10 shares
HAROLD C. JOHNSTON	10 shares
WILLIAM B. FRANKLIN	10 shares
GEORGE M. DERY	10 shares
C. F. BROWN	10 shares
W. E. McCLINTOCK	10 shares
J. F. SHEPHERD	10 shares

[121]

Present:

K. G. Lawson
Harold C. Johnston
William B. Franklin
George M. Dery
C. F. Brown
W. E. McClintock
J. F. Shepherd.

Mr. W. E. McClintock was requested to act as chairman of the meeting and Harold C. Johnston as temporary secretary.

The chairman announced that Articles of Incorporation had been executed and filed in the office of the Secretary of State and in the office of the County Clerk of Los Angeles County and a certificate of incorporation had been issued by the Secretary of State, which said certificate and a copy of said articles of incorporation were thereupon presented and read to the meeting, and upon motion of director C. F. Brown, seconded by director K. G. Lawson, duly put and unanimously carried, it was:

“RESOLVED, that the action of the organizers of this Company in filing Articles of Incorporation as read before the meeting be, and the same is hereby approved and ratified, and that the certificate of incorporation and a copy of said Articles as read be filed in the records of the Company and that the appointment of the persons named in the said Articles of Incorporation, to-wit: K. G. Lawson, Harold C. Johnston, William B. Franklin, George M. Dery, C. F. Brown, W. B. McClintock and J. F. Shepherd as directors for the first year or until their successors are elected, be and the same is hereby ratified and approved.”

The Chairman announced that the next business in order was the adopting of a code of By-laws, and the Secretary pro tem thereupon presented and read the code of By-laws.

Whereupon, on motion of director J. F. Shepherd, seconded by director George M. Dery, duly put and unanimously carried, it was: [122]

“RESOLVED, that the code of By-Laws as read by the Secretary be and the same is hereby adopted as the By-laws of this company and that the said By-laws as read by the Secretary be engrossed in a book to be known as the Company’s Book of By-Laws, and when so engrossed in said book the directors and duly elected Secretary of this Company be requested to certify the same.”

Director K. G. Lawson tendered her written resignation as a director of this Corporation, which resignation upon motion of director Harold C. Johnston, seconded by director C. F. Brown, duly put and carried was accepted to take effect at once.

Thereupon, upon motion of director W. E. McClintock, seconded by Director Harold C. Johnston duly put and carried, Dan W. Green was elected a director of this corporation in the place of said director K. G. Lawson resigned, and took his seat on the board of directors as such.

Thereupon director Harold C. Johnston tendered his written resignation as a director and upon motion of director William B. Franklin, seconded by director J. F.

Shepherd, duly put and unanimously carried said resignation was accepted to take effect at once.

Upon motion of director Dan W. Green said Harold C. Johnston was requested to continue to act as temporary secretary of this meeting until the conclusion thereof and consented to so do.

Thereupon on motion of director Dan W. Green, seconded by director W. E. McClintock, duly put and unanimously carried, Douglas W. Wilson was unanimously elected to fill the vacancy on said board and took his seat on said board.

Thereupon director William B. Franklin tendered his written resignation as a director, which resignation was upon motion of director George M. Dery, seconded by director C. F. Brown, duly put and unanimously carried, and accepted to take effect at once. [123]

Thereupon, upon motion of director W. E. McClintock, seconded by director J. F. Shepherd, duly put and unanimously carried, C. A. Page was elected to fill the vacancy caused by the resignation of said William B. Franklin as a director and took his seat on said board.

Thereupon, director George M. Dery tendered his resignation as such director, which resignation was upon motion of director C. F. Brown, seconded by director W. E. McClintock, duly put and unanimously carried, accepted to take effect at once.

Thereupon, on motion of director Douglas W. Wilson, seconded by director Dan W. Green, Walter F. Haas was

unanimously elected to fill the said vacancy caused by the resignation of said George M. Dery and took his place on said board as such director.

Thereupon, Director C. F. Brown tendered his written resignation as a director and upon motion of director Dan W. Green, seconded by director Walter F. Haas, duly put and unanimously carried, said resignation was accepted to take effect at once.

Thereupon, on motion of director C. A. Page, seconded by director Douglas W. Wilson, duly put and unanimously carried, G. V. Allen was unanimously elected to fill the vacancy on said board caused by the resignation of said director C. F. Brown and took his place on said board.

Thereupon, director W. E. McClintock tendered his written resignation as a director to take effect at once, which resignation was on motion of director Walter F. Haas seconded by director Dan W. Green, unanimously accepted to take effect at once.

Upon motion duly put and unanimously carried, W. E. McClintock was requested to continue to act as temporary chairman of this meeting until the conclusion thereof, and consented to so do.

Thereupon, on motion of director Walter F. Haas, seconded by director Douglas W. Wilson, William W. Roe was unanimously elected a director [124] to fill the vacancy caused by the resignation of W. E. McClintock but did not immediately take his seat on said board due

to the incumbency of said W. E. McClintock as temporary chairman of this meeting.

Thereupon, director J. F. Shepherd tendered his resignation as a director, which resignation was upon motion of director C. A. Page, seconded by director G. V. Allen, duly put and unanimously carried, accepted to take effect at once.

Thereupon, on motion of director Douglas W. Wilson, seconded by director Walter F. Haas, duly put and unanimously carried, Alfred A. McDowell was unanimously elected to fill the said vacancy so caused by the resignation of J. F. Shepherd and took his seat on said board.

On motion duly made, seconded and carried, the meeting was declared adjourned.

Approved W. E. McClintock
Temporary Chairman.

Harold C. Johnston
Temporary Secretary.

FIRST MEETING OF DIRECTORS OF THE
"CONSOLIDATED PRINTING AND PUBLISH-
ING COMPANY", a corporation, held at 718 Citi-
zens National Bank Building, Los Angeles, Califor-
nia, on the 2nd day of August, 1929, at the hour of
3:15 o'clock P.M. of said day, pursuant to the fol-
lowing written consent and waiver of notice. [125]

“EXHIBIT E”

THIS AGREEMENT made and entered into this 20th day of June, 1929 by and between THE DAILY JOURNAL COMPANY, a corporation duly incorporated under the laws of the State of California and having its principal place of business at the City of Los Angeles, County of Los Angeles, State of California, party of the first part, and LEGAL PUBLISHING COMPANY, a corporation, likewise organized under the laws of the State of California and having its principal place of business at the City of Los Angeles, County of Los Angeles, State of California, party of the second part,

W I T N E S S E T H:

Whereas, said party of the first part now is and for many years last past has been actively engaged in printing and publishing a daily newspaper in the City of Los Angeles, County of Los Angeles, State of California known as “The Los Angeles Daily Journal” and,

Whereas, said second party now is and for some years last past has been actively engaged in printing and publishing a daily newspaper in the City of Los Angeles, County of Los Angeles, State of California, known as “The Los Angeles News”, and

Whereas, each of said newspapers is largely devoted to the same kind of publication, to-wit, legal, and

Whereas, each of said parties now has a plant devoted to such publication and a subscription list as well as a more or less fixed clientele and patronage; and

Whereas, said parties are desirous of and deem it for the best interests of all concerned to consolidate their said properties; and

Whereas, such consolidation is pursuant to a general plan of reorganization; [126]

NOW THEREFORE, in consideration of the premises and the covenants hereinafter set forth, said parties hereby covenant and agree to form a new corporation either under the laws of the State of California or some other State to be mutually agreed upon, with a capital stock to consist of the following numbers and kind of shares of stock, to-wit: fifteen hundred (1500) shares of the par value of \$100.00 each of "Class A" cumulative preferred stock to bear interest at the rate of 7% per annum, to have the preference as to dividends and under liquidation of all other preferred as well as common stock and to be subject to redemption, cancellation and retirement at any time after one (1) year from the date of its issuance upon payment of its par value and accrued interest; five thousand (5,000) shares of "Class B" preferred stock par value \$100.00 each to bear interest at the rate of 20% per annum, to be cumulative, to have preference as to dividends and liquidation over the common stock but to be subordinate to said "Class A" preferred stock and to be not subject to redemption, cancellation or retirement; three thousand five hundred (3,500) shares of common stock without par value, to bear no fixed interest or dividends and to be not subject to redemption.

All three (3) classes of stock to be vested with equal voting power.

As soon as said corporation shall have been fully organized and the permit of the corporation Commissioner of the State of California, if said corporation be organized under the laws of the State of California, shall have been

procured therefor, or if said corporation shall be organized under the laws of another state, then when all of the laws of said other state and of said State of California relating to the issuance of said [127] stock shall have been complied with, said stock shall be issued and delivered as follows: To said Daily Journal Company so many of the shares of said "Class A" preferred stock as the same at par shall represent and equal the reasonable value of the physical properties of the plant of said Daily Journal Company devoted to the printing and publication of said "The Los Angeles Daily Journal" there shall be issued to said Legal Publishing Company so many of shares of said "Class A" preferred stock as the same at par shall represent and equal the reasonable value of the physical properties of the plant of said Daily Journal Company devoted to the printing and publishing of said "The Los Angeles Daily Journal" there shall be issued to said Legal Publishing Company so many of shares of said "Class A" preferred stock as the same at par shall represent and equal the reasonable value of the physical property that said Legal Publishing Company is now using in its plant for printing and publishing said "The Angeles News", it being nevertheless understood that said Legal Publishing Company shall have the right to retain such portion of said physical properties as it sees fit for use in the publication of other non-competing periodicals or publications.

It is further understood that included in the term physical assets to be turned over to said new company by said Legal Publishing Company for the purposes hereof, is included the shares or interest that said Legal Publishing Company owns in that certain co-partnership known as the California Independent.

It is hereby further covenanted and agreed that in consideration of the "Class B" preferred stock and the common stock to be delivered to the Daily Journal Company as hereinafter set forth, said Daily Journal Company shall sell, assign, transfer and set over to said new corporation the business and good will including subscription lists, advertising lists, incompletd advertising contracts, incompletd printing [128] contracts and incompletd publication contracts from and after the 1st day of July, 1929 of that certain newspaper known and designated as The Los Angeles Daily Journal printed, published and circulated in the City of Los Angeles, County of Los Angeles, State of California, and also the good will and business including subscription lists, advertising lists, incompletd advertising contracts, incompletd publication contracts and incompletd business of that certain newspaper owned by said Daily Journal Company known and designated as "The Daily Recorder" printed, published and circulated in the City of Los Angeles, County of Los Angeles, State of California.

It is hereby further covenanted and agreed that for and in consideration of the "Class B" preferred stock and common stock to be issued and delivered to said Legal Publishing Company as hereinafter set forth, said Legal Publishing Company shall sell, assign, transfer and set over to said new corporation the good will and business of said newspaper printed, published and circulated in the City of Los Angeles, County of Los Angeles, State of California, known and designated as "The Los Angeles News" together with all subscription lists, advertising contracts, incompletd advertising contracts, incompletd publications contracts, incompletd printing contracts and in-

completed business generally of said The Los Angeles News, and shall also sell, assign, transfer and set over to said new corporation that certain newspaper or publication printed, published and —— circulated in the City of Los Angeles, County of Los Angeles, State of California, known and designated as the "Greater Los Angeles" together with its subscription lists, incompleted advertising contracts, incompleted printing contracts, incompleted publication contracts and incompleted business generally.

It is hereby further mutually covenanted and agreed that the said new corporation shall complete all unfinished printing and publishing required under such incompleted contracts of each of the publications or [129] newspapers hereinabove referred to, and that if such business shall have been procured and such contracts made for such advertising, printing or publication prior to July 1st, 1929, the party hereto which has procured such business and commenced such publication or printing shall be entitled to collect the charges therefor, and that said new corporation shall not make any charge to or against the company originating said business for completing such publications.

It is hereby further covenanted and agreed that the executive officers of said new corporation shall not charge or receive any salary for their services rendered to said corporation unless otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation.

In consideration of the premises and of the said several assignments, the said "Class B" preferred stock shall be issued to and delivered to, first: 3,750 shares thereof to said Daily Journal Company, and 1250 shares thereof to said Legal Publishing Company, and the said common

stock shall be issued to and delivered to the said respective parties, as follows: 2,625 shares thereto to said Daily Journal Company and 875 shares thereof to said Legal Publishing Company.

It is hereby further covenanted and agreed that neither the said Daily Journal Company nor the said Legal Publishing Company, nor the stockholders thereof, nor the said other publications owned by said two companys hereinabove referred to, except said California Independent, shall directly or indirectly enter into any competition with said new corporation for business of the character and kind heretofore done by said Daily Journal Company and said Legal Publishing Company insofar as the same pertains to the printing, publishing and circulating any newspaper or periodical for legal advertising, except as may be from time to time mutually agreed upon in writing. [130]

It is hereby further covenanted and agreed that at the option of said newly organized company, it may continue the publication of said The Los Angeles Daily Journal and the publication of said The Los Angeles News through the corporate organizations heretofore publishing said papers, for such length of time as said new corporation may deem advisable and for that purpose be permitted to use the name and organization of each of said companys, provided that in that event said new corporation shall pay any taxes and licenses required to be paid by said respective companys during said period.

It is hereby further covenanted and agreed that said new corporation shall have ample powers and the Articles of Incorporation shall so specify to enable it to carry out all of the foregoing plans and purposes, to engage in the

printing and publishing business; to buy and sell stock in other corporations; to own patents and patent rights; to own franchises for publications, and the obtaining and circulation of news items, and in brief, all powers usually and ordinarily had by first class newspaper corporations, including the power to buy and sell the necessary real estate for its operations.

It is hereby further covenanted and agreed that neither of the contracting parties shall sell any of the stock that may be to them issued pursuant to the terms hereof in the said new corporation without having first given to the other contracting party sixty (60) days written option to purchase such stock so intended to be sold, at a price equal to any bona fide offer that may have been made to the selling party for such stock.

It is hereby further covenanted and agreed that from and after July 1st, 1929, all collections for unfinished business of each of the contracting parties up to, or contracted prior to the 1st day of July 1929, shall be made through said new corporation, or by a trustee to be appointed by the parties hereto for said purpose if the organization of said [131] new corporation shall not have been completed, for the interim up to the time the organization of said new corporation shall have been completed pursuant hereto, and that for all such moneys so collected through said Trustee or said new corporation for such business contracted for and unfinished by July 1, 1929 and retained by said new corporation, said new corporation being hereby authorized to retain the same, or said trustee on its behalf to retain the same until the organization of said new corporation shall have been perfected, shall be issued to the contracting party to whom said money belongs under the provisions

of this agreement, Class A stock at par equal to the amounts so collected and retained.

It is hereby further covenanted and agreed that in the ascertainment of the reasonable value of the physical properties to be so assigned and transferred to said new corporation by each of the contracting parties hereto, said contracting parties shall endeavor to agree so far as possible, but that if they shall fail to agree, each of said contracting parties shall nominate and appoint an appraiser who shall respectively appraise said properties and if said two appraisers shall fail to agree, said appraisers shall have the right to appoint a third appraiser or umpire and the written determination or appraisal of any two out of said three appraisers shall be taken as the basis for the issuance of said "Class A" preferred stock in payment of such physical properties.

It is hereby further covenanted and agreed that said new corporation shall, at its option, be entitled to receive from each of the contracting parties an assignment and transfer insofar as said contracting party can make such assignment and transfer, of any contractual rights that the said contracting party may have appertaining to the printing and publishing of legal advertising of all kinds in the present newspapers operated by and published by said contracting parties hereinabove expressly mentioned and to be transferred to said new corporation, and also any contracts and [132] contractual rights said contracting party may have with its employees or any employee of said contracting party.

It is hereby further covenanted and agreed that each of the said contracting parties and the stockholders of said contracting parties so far as the same can be bound by

this agreement, will use their best efforts and endeavors to further and promote the business of said new corporation.

It is hereby further covenanted and agreed that W. E. Roe be, and he is hereby appointed the Trustee for the collection of the accounts for such unfinished business contracted prior to July 1, 1929 by the respective parties hereinabove referred to, and to dispose of such collections in the manner hereinabove set forth.

IN WITNESS WHEREOF, the said respective corporations have pursuant to resolutions by them respectively adopted, caused these presents to be executed in duplicate by their respective Presidents and to be attested by their respective Secretaries and the seals of said respective corporations to be hereunto affixed the day and year hereinabove first written.

DAILY JOURNAL COMPANY,
A Corporation,

By
Its President.

ATTEST:

.....
Its Secretary.

LEGAL PUBLISHING COMPANY,
A Corporation,

By
Its President.

ATTEST:

.....
Its Secretary.

[133]

"EXHIBIT C"

We, the undersigned, being all of the directors of the "Consolidated Printing and Publishing Company" hereby consent to the holding of the first meeting of the Board of Directors of said Company at 718 Citizens National Bank Building, Los Angeles, California, on the 2nd day of August, 1929, at the hour of 2:15 o'clock P. M. of said day, for the purpose of organizing the board, electing officers and transacting such other business as may properly come before the board, and we hereby waive further notice of the time and place of such meeting.

Dated at Los Angeles, California, the 2nd day of August, 1929.

Dan W. Green
Douglas W. Wilson
C. A. Page
Walter F. Haas
G. V. Allen
William W. Roe
Alfred A. McDowell.

Present: Douglas W. Wilson, Walter F. Haas, William W. Roe, Dan W. Green, C. A. Page, G. V. Allen and Alfred A. McDowell.

Mr. Douglas W. Wilson was requested to act as chairman of the meeting and appointed Mr. William W. Roe as temporary Secretary.

The temporary Secretary read the code of By-laws adopted by the stockholders, and on motion of director

Walter [134] F. Haas, seconded by director C. A. Page, duly put and unanimously carried, it was:

“RESOLVED, that each member of the Board of Directors and duly elected Secretary of the Company be, and they are hereby requested to subscribe their names to the said By-laws and to certify the same in the book of By-laws.”

Thereupon, on nominations regularly made, duly put and unanimously carried, the following persons were elected and declared to be the officers of this Company until the further order of this Board, to-wit:

Douglas W. Wilson	President
C. A. Page	First Vice-President
Walter F. Haas	Second Vice-President
William W. Roe	Treasurer
Dan W. Green	Secretary.

On motion duly made, seconded and carried, it was:

“RESOLVED, that the forms for the stock certificates covering the several kinds of stock of this corporation, to-wit: “Class A” preferred stock, “Class B” preferred stock and “Common” stock, read by the Secretary be, and the same are hereby adopted for the use of this Company, and that the Secretary be, and he is hereby authorized and directed to procure a book of stock certificates in the form presented and read by him and also the necessary record books for the use of the company and that the Secretary be, and he is hereby authorized and directed to procure a seal having thereon the words and figures provided for in the By-laws.”

Upon motion of director Dan W. Green, seconded by director Alfred A. McDowell, duly put and unanimously carried, the following resolution was adopted:

“RESOLVED, that the California Bank, a banking corporation, doing business in the City of Los Angeles, County of Los Angeles, State of California, be and the same is here- [135] by selected as the depository of all funds of this Corporation.”

Upon motion of director William W. Roe, seconded by director C. A. Page, duly put and unanimously carried, it was:

RESOLVED, that a regular checking account be opened by this Corporation with California Bank, a banking corporation, doing business at the City of Los Angeles, County of Los Angeles, State of California, and that all checks of this corporation, drawn on the same shall be signed by the President or one of the Vice Presidents and countersigned by the Secretary.”

Upon motion of director Walter F. Haas, seconded by director C. A. Page, the following resolution was adopted:

“RESOLVED, that a petition or application be made on behalf of this Corporation to the Corporation Commissioner of the State of California for leave to issue to The Daily Journal Company, a corporation, duly incorporated under the laws of the State of California, in consideration of the transfer and conveyance by the said The Daily Journal Company to the Consolidated Printing and Publishing Company of certain tangible assets and properties of the said The Daily Journal Company, particularly described in an inventory filed with the Secretary of said Consolidated Printing and Publishing Company, shares of the “Class A” preferred stock of said Consolidated Printing and Publishing Company;

also to issue to Legal Publishing Company in consideration of the transfer and conveyance to said Consolidated Printing and Publishing Company of certain tangible assets described in an inventory filed with the Secretary of said Consolidated Printing and Publishing Company shares of the "Class A" preferred stock of said Consolidated Printing and Publishing Company; also to issue to said The Daily Journal Company in consideration of the transfer, assignment and conveyance by said The Daily Journal Company to said Consolidated Printing and Publishing Company of the good will, business, franchises, subscription lists, advertising lists and other properties mentioned and referred to in that certain contract dated the 20th day of June, 1929, made and entered into by and between The Daily Journal Company, a corporation, as party of the first part, and Legal Publishing [136] Company, a corporation, as part of the second part, 3,750 shares of the "Class B" preferred stock of said Consolidated Printing and Publishing Company; also to issue to Legal Publishing Company, in consideration of the transfer, assignment and conveyance by said Legal Publishing Company to said Consolidated Printing and Publishing Company of the good will, business, franchises, subscription lists and other assets to be transferred to said Consolidated Printing and Publishing Company as recited in that certain contract so dated the 20th day of June, 1929, made and entered into between The Daily Journal Company, a corporation, as party of the first part, and Legal Publishing Company, a corporation, as party of the second part, 1250 shares of said "Class B" preferred stock of said Consolidated Printing and Publishing Company: also in consideration of the said transfer of said business, good will, and assets hereinabove mentioned by said The Daily Jour-

nal Company, to issue to said The Daily Journal Company 2625 shares of the common stock of said Consolidated Printing and Publishing Company; also to issue to said Legal Publishing Company in consideration of the transfer, assignment and conveyance of said business, good will and assets hereinabove recited to be conveyed to said Consolidated Printing and Publishing Company 875 shares of the "Common" stock of said Consolidated Printing and Publishing Company. That of the said stock so to be issued to said The Daily Journal Company, said corporation, as aforesaid, to be transferred to Dan W. Green, Marie McManus, Katheryn G. Lawson and Elmer G. Riggin in consideration of the transfer and conveyance by them to said Consolidated Printing and Publishing Company of all of the interests held by said persons in a certain newspaper and its assets, printed and published at Los Angeles, California, known and designated as "California Independent", 210.9375 shares of said "Class B" preferred stock and 122.325 shares of said "Common" stock, and out of said stock to be issued to said Legal Publishing Company as aforesaid, there is to be transferred and issued to said persons, to-wit: Dan W. Green, Marie McManus, Katheryn G. Lawson and Elmer G. Riggin 70.3125 shares of "Class B" preferred stock and 40.775 shares of "Common" stock. That likewise out of the said stock so to be issued to said The Daily Journal Company, there is to be issued to Dan W. Green in consideration of the sale, assignment and transfer by the said Dan W. Green to said Consolidated Printing and Publishing Company of the one-half ($\frac{1}{2}$) interest of the said Dan W. Green in and to a certain newspaper and its plant known and designated as "Los Angeles Review" printed and published [137] at the City of Los Angeles, County of Los An-

ges, State of California, 281.25 shares of "Class B" preferred stock and 163.275 shares of the "Common" stock, and by said Legal Publishing Company 93.75 shares of said "Class B" preferred stock and 54.425 shares of said "Common" stock.

BE IT FURTHER RESOLVED, that said Corporation Commissioner be requested to permit the sale of all of the remainder of the "Class A" preferred stock at its par value, without the payment of any brokerage, the moneys derived from such sale to be placed in the treasury of this Company and to be used in the same manner as other moneys used in the business of and for the development of this Company, and

BE IT FURTHER RESOLVED, that the President and Secretary and directors of this Company be authorized to take such steps and to execute such documents in the name of this Company as may be necessary or convenient to obtain from the Corporation Commissioner the permit hereinabove referred to."

Upon motion of Dan W. Green, seconded by director C. V. Allen, the following resolution was unanimously adopted, to-wit:

"RESOLVED, that the firm of Haas and Dunnigan, attorneys at law, be and the same are hereby retained as the attorneys for said Consolidated Printing and Publishing Company at a retainer of One Hundred (\$100.00) Dollars per month dating from the 1st day of July, 1929,"

There being no further business to come before the meeting, the same was declared adjourned.

APPROVED: Douglas W. Wilson

ATTEST:

President.

Dan W. Green

Secretary

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“EXHIBIT F”

THIS AGREEMENT made and entered into this 29th day of JUNE, 1929 by and between THE DAILY JOURNAL COMPANY, a corporation, and LEGAL PUBLISHING COMPANY, a corporation, each organized and existing under the laws of the State of California, and each having its principal place of business at the City of Los Angeles, County of Los Angeles, State of California, parties of the first part, and DAN W. GREEN, ELMER G. RIGGINS, MARIE McMANUS and KATHERYN G. LAWSON, all of the City of Los Angeles, County of Los Angeles, State of California, parties of the second part,

W I T N E S S E T H:

Whereas, said Daily Journal Company, a corporation and said Legal Publishing Company, a corporation, have heretofore, to-wit, on the 20th day of June, 1929, made and entered into a contract in writing for the formation of a new corporation to be known as “CONSOLIDATED PRINTING AND PUBLISHING COMPANY” under the laws of the State of California, with its principal place of business at the City of Los Angeles, and for the conveyance to said corporation of certain tangible and intangible properties of said respective corporations in said contract mentioned to said new corporation; said new corporation to have three (3) classes of stock, to-wit: “Class A” preferred stock, “Class B” preferred stock and “Common Stock”; the terms and conditions of which said contract are known to all of the parties hereto; and

Whereas, said Second Parties are the owners of the following interests in a certain newspaper and its assets,

known and designated as "California Independent" printed and published at the City of Los Angeles, County of Los Angeles, State of California, to-wit: Dan W. Green, a one-quarter ($1/4$) interest; Marie McManus, a one-sixth ($1/6$) interest; Katheryn G. Lawson, a one-sixth ($1/6$) interest and Elmer G. Riggins, a one-sixth ($1/6$) interest; the other one-quarter ($1/4$) interest belonging [139] to said Legal Publishing Company, and being covered by said contract between said Daily Journal Company and said Legal Publishing Company, hereinabove referred to; and

Whereas, said Second Parties are willing to convey said California Independent and its properties to said "Consolidated Printing and Publishing Company", said corporation about to be formed, as soon as the same is formed, for the consideration hereinafter named; such conveyance to be made pursuant to a general plan of reorganization.

NOW THEREFORE, this Agreement Witnesseth:

That as soon as said "Consolidated Printing and Publishing Company" shall have been organized and authorized to issue its capital stock and shall have a permit to so do, said Parties of the Second Part will sell, assign, transfer and set over unto said "Consolidated Printing and Publishing Company," said corporation, all their right, title, interest and estate in and to said newspaper, said "California Independent", together with its contracts, contractual rights, good will and office furniture and equipment, and will execute all documents necessary or con-

venient to so do, in consideration of which said parties of the First Part covenant and agree that they will respectively assign and transfer to said Second Parties collectively, or segregate among said Second Parties as directed in writing the following stock in said "Consolidated Printing and Publishing Company", to-wit: Said Daily Journal Company 210.9375 shares of "Class B" preferred stock and 122.325 shares of Common Stock, and said Legal Publishing Company 70.3125 shares of stock said "Class B" preferred stock and 40.775 shares of said common stock.

It is hereby further covenanted and agreed that said Second Parties will assign to W. W. Roe, who is hereby appointed Trustee for all the parties hereto for that purpose all the book accounts and bills receivable of said "California Independent" for any work commenced or advertising started prior to the 1st day of July, 1929, and as the same [140] are collected by said W. W. Roe, the money derived from such collections shall be turned into the Treasury of said "Consolidated Printing and Publishing Company" to be by it retained and "Class A" preferred of said "Consolidated Printing and Publishing Company" shall be issued to said Second Parties or upon their order in amounts at par equal to three-fourths ($\frac{3}{4}$) of such collections. Said W. W. Roe shall continue to act as such Trustee to collect all accounts and bills receivable for work done or advertising contracted by said California Independent subsequent to July 1st, 1929 and up to the full organization of said "Consolidated Printing and Publish-

ing Company” and out of such collections pay all operating expenses of said “California Independent” during the interim, turning over the balance if any, to said “Consolidated Printing and Publishing Company”. Should such collections be insufficient to pay such operating expenses, the deficit shall be paid by said “Consolidated Printing and Publishing Company” when the same shall have been organized.

It is hereby further covenanted that all accounts are to be audited as of July 1st, 1929 and that pending the completion of said organization of said “Consolidated Printing and Publishing Company” W. W. Roe shall act as trustee of the Parties hereto for the collection of all accounts, bills and notes receivable of said “California Independent” and shall out of such sums so collected, pay the current operating expenses and salaries of said “California Independent” pending the final consummation of this agreement.

It is hereby further covenanted and agreed that insofar as the same has a bearing upon or affects the carrying out of this contract, the terms, covenants and conditions of said contract between said Daily Journal Company and said Legal Publishing Company shall be deemed a part hereof.

IN WITNESS WHEREOF, said First Parties have each caused this agreement to be executed in its respective corporate name by its [141] President or Vice President and its corporate seal to be hereunto affixed by its Secre-

tary pursuant to resolutions adopted by its respective Board of Directors and said Second Parties have hereunto set their hands and seals, and these presents have been executed in triplicate the day and year hereinabove first written.

DAILY JOURNAL COMPANY,

By:

Its President

ATTEST:

.....

Its Secretary

LEGAL PUBLISHING COMPANY

By:

Its President.

ATTEST:

.....

Its Secretary

..... (SEAL)

..... (SEAL)

..... (SEAL)

..... (SEAL)

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“EXHIBIT G”

THIS AGREEMENT made and entered into this 29th day of June, 1929, by and between DAILY JOURNAL COMPANY, a corporation, and LEGAL PUBLISHING COMPANY, a corporation, each organized and existing under the laws of the State of California, and each having its principal place of business at the City of Los Angeles, County of Los Angeles, State of California, parties of the first part, and Dan W. Green of the same place, party of the second part,

W I T N E S S E T H :

Whereas, said Daily Journal Company and said Legal Publishing Company have heretofore, to-wit: on the 20th day of June, 1929, made and entered into a contract in writing with each other whereby and whereunder a new corporation, to be known as “Consolidated Printing and Publishing Company” is to be organized under the laws of the State of California, with three (3) classes of stock, to-wit “Class A” preferred stock, “Class B” preferred stock and “Common Stock” to which said new corporation each of said corporations, parties of the first part herein, are to convey certain properties in said contract described, in consideration of the issuance to each of such parties of the first part herein of certain of the stock of said “Consolidated Printing and Publishing Company” when the same shall have been fully organized and the permit therefore obtained from the Corporation Commissioner of the State of California, the terms, covenants and conditions of which said contract are known to all the parties hereto; and

Whereas said second party is the owner of an undivided one-half interest in and to a certain newspaper and its

plant known and designated as "Los Angeles Review", printed and published at the City of Los Angeles, County of Los Angeles, State of California, and

Whereas said second party is desirous of selling half [143] interest in and to said "Los Angeles Review" and its said "Consolidated Printing and Publishing Company" when organized and said first parties are desirous of having said "Consolidated Printing and Publishing Company" purchase the one-half interest from said second party as of July 1, 1929, for the considerations hereinafter named:—

NOW THEREFORE this Agreement Witnesseth:

That said first parties will respectively assign and transfer to said second party, as soon as the same shall have been legally issued to said first parties, the following stock of said "Consolidated Printing and Publishing Company" to-wit: an inventory shall be made of the tangible assets of said "Los Angeles Review" and the parties hereto shall endeavor to agree upon the reasonable value thereof; if said parties shall fail to agree, each of said parties shall select an appraiser to appraise the said tangible assets, and if said two appraisers shall fail to agree said two appraisers shall select a third appraiser or umpire and the written appraisal of any two out of said three appraisers shall be binding on the parties hereto and shall constitute the basis of the amount of "Class A" preferred stock to be issued to such second party and there shall be issued to said second party in "Class A" preferred stock of said "Consolidated Printing and Publishing Company" equal at par to one half the said appraised value of said tangible assets. Said "Class A" preferred stock so issued to said Second Party shall be issued out of the Treasury Stock

of said "Consolidated Printing and Publishing Company. There shall likewise be assigned and transferred to said second party out of the stock to first parties in said "Consolidated Printing and Publishing Company" pursuant to said contract of June 20th, 1929 hereinabove mentioned, in the proportions of three-fourths ($3/4$) thereof by said Daily Journal Company, said corporation, and one-fourth ($1/4$) thereof by said Legal Publishing Company three hundred and seventy-five (375) shares of "Class B" preferred stock; there shall likewise be assigned and transferred out of the "Common [144] Stock" issued to said first parties under said contract of June 20, 1929, by said Daily Journal Company 163.275 shares and by said Legal Publishing Company 54.425 shares.

In consideration of such assignment and transfer to said Dan W. Green said second party, he hereby covenants and agrees to sell, assign and transfer to said "Consolidated Printing and Publishing Company" his one-half interest in and to said "Los Angeles Review" its business and assets, including the tangible assets, book accounts, arising out of business contracted for after July 1, 1929, bills receivable, good will, trade name and any and all property of the copartnership in said "Los Angeles Review" heretofore and now existing between said Dan W. Green and George P. Reuter, it being understood that said George P. Reuter retains his one-half interest in and to the same.

In further consideration of the premises and the sum of \$10.00 per annum to be said second party paid by said

“Consolidated Printing and Publishing Company” said second party covenants and agrees that he will for the period of five (5) years from and after the 1st day of July, 1929 devote his time and personal attention as heretofore to the management and operation, subject to the control of the Board of Directors of said “Consolidated Printing and Publishing Company”, of said “Los Angeles Review”, said newspaper, and also of the “California Independent” in which said Dan W. Green said second party heretofore had a one-quarter ($1/4$) interest, which he has agreed to convey to said “Consolidated Printing and Publishing Company,” it being understood that in addition to said \$10.00 he has received 125 of the 375 shares of “Class B” preferred stock as full compensation for such services so to be rendered.

In further consideration of the premises said second party covenants and agrees that so long as said “Consolidated Printing and Publishing Company” shall continue in business in the County of Los Angeles, State of California, said second party will not engage in a [145] similar line of business in said County in competition with said “Consolidated Printing and Publishing Company.”

It is further covenanted and agreed that, insofar as the same relate to or affect the terms of this contract, all provisions contained in said contract so made and entered into on the 30th day of June, 1929 by and between said Daily Journal Company and said Legal Publishing Company, shall be deemed to be incorporated herein.

It is further understood and agreed that said assignment and transfer by second party includes all rights of second party in, to and under the lease of the premises occupied by said "Los Angeles Review" and all benefits that may accrue from the same.

IN WITNESS WHEREOF, said first parties have caused these presents to be executed in their corporate seals to be hereto affixed by their respective Secretaries and said second party has hereunto set his hand and seal and these presents have been executed in triplicate the day and year first above written.

DAILY JOURNAL COMPANY

By
Its Vice-President.

ATTEST:

.....
Its Secretary.

LEGAL PUBLISHING COMPANY

By
Its President.

ATTEST:

.....
Its Secretary.

..... (SEAL)

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EXHIBIT "H"

THIS AGREEMENT made and entered into this 3rd day of July, 1929, by and between GEORGE P. REUTER of the City of Los Angeles, County of Los Angeles, State of California, party of the first part and "DAILY JOURNAL COMPANY", a corporation, "LEGAL PUBLISHING COMPANY", a corporation, "CALIFORNIA INDEPENDENT", a copartnership and DAN W. GREEN, all of the same place, parties of the Second Part,

WITNESSETH:

WHEREAS, said first party is the owner of an undivided one-half interest in and to a certain newspaper known and designated as "Los Angeles Review", printed and published at the City of Los Angeles, County of Los Angeles, State of California, together with its business and assets, and

WHEREAS, the parties of the Second Part are about to form a corporation under the laws of the State of California, under the name of "Consolidated Printing and Publishing Company", with its principal place of business at the City of Los Angeles, County of Los Angeles, State of California, and

WHEREAS, said Dan W. Green has entered into a contract with said "Daily Journal Company" and said "Legal Publishing Company" to convey his one-half interest in and to said "Los Angeles Review" together with

its business and assets, to "Consolidated Printing and Publishing Company", when fully organized, and

WHEREAS, said First Party has now and heretofore has had an agreement with said Dan W. Green, that if said First [147] Party should desire to sell his interest in the partnership between himself and said Dan W. Green doing business as "Los Angeles Review," said First Party would at any time within thirty (30) days after receiving a bona fide offer for his interest in such "Los Angeles Review," said newspaper, and its assets, sell such interest to said Dan W. Green at the price so established by such bona fide offer or offers; and

Whereas by his said contract with said "Daily Journal Company" and said "Legal Publishing Company" for the sale of the interest of said Dan W. Green in said "Los Angeles Review" hereinabove referred to, said Dan W. Green had covenanted and agreed to devote his time and attention for the period of five (5) years from and after the 1st day of July, 1929, to the management and superintendence of the affairs and business of said "Los Angeles Review" for the compensation in said contract mentioned; and

Whereas, said First Party will receive certain benefits from the acquisition by said "Consolidated Printing and Publishing Company" of the interest of said Dan W. Green in said "Los Angeles Review";

NOW THEREFORE, in consideration of the premises said First Party hereby covenants and agrees to and

with the Second Parties that said First Party will, if he desires to sell his interest in said "Los Angeles Review" not for a period of 30 days from the date of any bona fide offer for such one-half interest or any interest in and to said "Los Angeles Review" sell the same to anyone without first having offered to sell the same to said "Consolidated Printing and Publishing Company" at the same price and on the same terms as the highest and best bona fide offer by First Party received for the same in which event said "Consolidated Printing and Publishing Company" shall have 30 days from receipt of such offer in writing from said First Party stating the price and terms of such bona fide offer made to said First Party, to purchase said one-half interest of said First Party in said copartnership, in which event said party will [148] upon receipt of the purchase price therefor sell, assign and transfer such interest to said "Consolidated Printing and Publishing Company", said corporation so to be formed.

IN WITNESS WHEREOF, said First Party has executed these presents in triplicate the day and year first above written.

..... (SEAL)

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EXCERPTS FROM THE TRANSCRIPT OF
TESTIMONY

(RE OBJECTIONS OF RESPONDENT AS
SUSTAINED)

The Member: Let the questions and answers on cross examination be included in the offer, and the deposition as a whole will be admitted in evidence.

Now, you said there was one minor exception to that general statement as to the nature of the evidence in the deposition.

Mr. Latham: I note here a question by me, for example, as to whether—

Mr. Tonjes: What page?

Mr. Latham: Page 8. This is addressed to Douglas W. Wilson:

“Q. Were your duties, when you became president in 1917, any different than those formerly performed by your father?

“Mr. Tonjes: That is objected to as being immaterial and incompetent and having no bearing on the issues.”

Now, that does not cover the general situation. I don't know that the question is of any particular importance, anyway.

The Member: It doesn't seem to me that it is pertinent, why it would make any difference whether his duties were the same.

Mr. Latham: Merely to show we had a continuous action with respect to this company from the time it was

formed up until the time of consolidation. In other words, it has been a one-man company, you might say, so far as operation is concerned, from 1895 to present.

The Member: That is going pretty far afield when we have 1936, 1937 and 1938 before us. The objection will be sustained as to that question and an exception allowed petitioner.

Mr. Latham: On page 9 this question is addressed to Mr. Wilson by me:

“Q. Since you became president of the Daily Journal Company in 1917, has the Commissioner of Internal Revenue, or any other governmental agency, ever questioned the reasonableness of the salary paid to you, except with respect to this present proceeding?”

“Mr. Tonjes: That question is objected to as being incompetent and immaterial, and having no bearing on the issues involved in this proceeding.”

It seems to me, if your Honor please, to be material in showing that no question had been raised about this until the years 1936, 1937 and 1938, even though the consolidation had occurred in 1929.

The Member: I have had that question up before me not infrequently, but the answer to that is: Let's suppose that this Commissioner in some previous year or some previous Commissioner had made some ruling, and if he was mistaken about it or had taken some line of action and was mistaken about it, we don't want to perpetuate anybody's mistakes in this world if we can help it. I think the objection is well taken. It will be sustained and an exception allowed the petitioner.

Mr. Latham: May I take a moment to glance through this and make sure I have all of the questions?

The Member: Yes, you had better do that because we will necessarily have to consider as waived all other objections except those you take up now.

Mr. Latham: I don't want to be in the position of misrepresenting anything intentionally.

Here is one on page 17 that may be of moment. I referred to a provision in the Consolidated contract of 1929, namely, that provision which read to the effect that no salary should be paid to any officer of a predecessor company without the unanimous consent of the board of directors of the new company. Then I asked this question of Mr. Wilson:

“Q. Why was that provision inserted in this contract between the Daily Journal Company and the Legal Publishing Company?

“Mr. Tonjes: That is objected to as not being the best evidence. The agreement speaks for itself, and it is incompetent and immaterial.”

I might state that nothing more is said with regard to that point. The reason does not appear anywhere in the contract or in any of the minutes which are submitted as evidence.

The Member: I think the objection is well taken. It is there, and I don't think it makes any difference why it was put in there. The objection will be sustained and an exception allowed petitioner.

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Petitioner's Exhibit One
DAILY JOURNAL COMPANY
Operations Prior to 1929

<u>YEAR</u>	<u>Gross Operating Income</u>	<u>Income before Officers' Salaries Or Income Taxes</u>	<u>Income before Income Taxes</u>	<u>Officers' Salaries</u>	<u>Dividends Paid</u>
1914	89,163.90	50,866.85	22,338.56	28,528.99	10,198.85
1915	85,886.14	48,442.83	19,174.42	29,268.41	15,871.51
1916	82,206.91	50,406.71	21,639.83	28,766.88	12,612.66
1917	80,069.67	48,782.88	31,651.07	17,131.81	48,239.83
1918	67,178.33	33,465.64	16,638.42	16,827.22	19,987.72
1919	65,125.25	30,251.41	13,485.31	16,766.10	8,866.87
1920	89,204.51	39,926.68	22,513.07	17,413.61	12,546.04
1921	94,188.23	43,149.04	24,936.10	18,212.94	9,769.48
1922	115,821.33	48,511.85	30,013.65	18,498.20	5,137.09
1923	140,818.39	64,300.27	45,512.88	18,787.39	13,789.99
1924	174,888.36	86,608.56	67,200.92	19,407.64	13,706.05
1925	170,180.02	82,666.73	62,760.62	19,906.11	8,319.30
1926	189,738.07	86,440.75	66,882.34	19,558.41	37,748.02
1927	186,442.00	61,696.88	42,392.76	19,304.12	
1928	187,033.54	58,192.50	39,803.23	18,389.27	130,000.00
1929 ¹	111,129.63	58,228.55	35,267.08	12,961.47	
Average	124,456.40	57,544.38	36,271.62	20,647.00	22,373.76

1—First half of 1929, the year of consolidation.

U. S. Board of Tax Appeals Div 4 Docket 105054 Admitted in Evidence Sep 24 1941 Petitioner's Exhibit One.

Petitioner's Exhibit Two
DAILY JOURNAL COMPANY
Operations Subsequent to 1929

YEAR	Dividends Rec'd. Consolidated Prig. and Pub. Co.	Income Carried Over from Prior Operations ¹	Interest from Banks	Other Income ²	Total Gross Income	Income Before Officers' Income Taxes	Income before Income Taxes	Officers' Salaries	Dividends Paid
1930	92,487.75	7,257.29	2,527.46	1,379.38	103,651.88	94,655.41	74,855.41	19,800.00	63,129.50
1931	78,176.40	1,564.66	3,525.90	1,214.94	84,481.90	82,602.39	62,152.39	20,450.00	66,924.82
1932	68,765.00	689.11	1,896.07	1,033.64	72,313.82	71,120.61	59,120.61	12,000.00	51,560.00
1933	59,182.33	631.02	1,590.12	1,063.65	62,467.12	60,056.72	48,056.72	12,000.00	39,117.50
1934	57,015.00	160.10	1,668.07	L-1,594.79	57,248.38	55,462.56	43,462.56	12,000.00	39,990.00
1935	33,598.13	224.39	1,038.49	L- 815.83	34,045.18	32,593.52	20,593.52	12,000.00	25,500.00
1936	31,561.88	97.87	581.82	182.45	32,424.02	30,849.42	18,849.42	12,000.00	33,000.00
1937	40,715.00	40.20	60.19	36.36	40,851.75	39,165.47	27,165.47	12,000.00	29,000.00
1938	30,543.75	54.50	53.12	L-3,878.86	26,772.51	25,471.12	13,471.12	12,000.00	13,500.00
1939	24,429.00	59.00	34.48	12.00	24,534.48	20,546.61	8,546.61	12,000.00	10,500.00
1940	26,471.25	25.50	—	17.00	26,513.75	24,680.06	12,680.06	12,000.00	12,000.00
Average	49,358.68	982.15	1,171.43	L- 120.91	51,391.34	48,836.72	35,359.44	13,477.27	34,929.26

¹—Pursuant to the consolidation agreement the constituent companies retained all receivables attributable to operations prior to July 1, 1929.

²—From 1926 to June 1, 1934 petitioner held approximately 60 shares of preferred stock of Los Angeles Gas & Electric Corporation. From 1927 to June 1, 1934 it likewise held 20 shares of preferred stock of Southern California Edison Company, Ltd.

U. S. Board of Tax Appeals, Div. 4 Docket 105054 Admitted
in Evidence Sep 24 1941 Petitioner's Exhibit Two.

[154]

Petitioner's Exhibit Three
DAILY JOURNAL COMPANY
Balance Sheets as of December 31, 1927-1940

<u>ASSETS</u>	Dec. 31 1927	Dec. 31 1928	Dec. 31 1929	Dec. 31 1930	Dec. 31 1931	Dec. 31 1932	Dec. 31 1933	Dec. 31 1934	Dec. 31 1935	Dec. 31 1936	Dec. 31 1937	Dec. 31 1938	Dec. 31 1939	Dec. 31 1940
CASH	83,823.15	59,449.66	65,382.15	60,217.56	66,454.64	59,445.41	66,842.38	59,194.14	47,050.22	45,937.00	7,445.30	6,318.54	3,208.13	3,145.69
ACCOUNTS RECEIVABLE	18,065.96	18,702.16	10,557.88	60,345.46	59,958.35	44,298.32	73,661.88	93,983.91	100,076.68	92,472.96	87,760.81	76,358.19	77,595.69	80,515.69
NOTES RECEIVABLE						51,801.81	56,561.81	56,561.81	56,561.81	56,561.81	56,566.81	72,801.81	71,000.00	70,500.00
AUTO	1,188.35	792.24	1,584.46	1.00	1.00	967.54	645.08	322.62	1.00					
PLANT (net)	8,944.17	5,375.24												
IMPROVEMENTS & LEASEHOLD		3,357.29	5,138.92	1,181.11		5,717.41	37,027.41	37,187.28	37,310.48	37,385.01	37,455.23	37,521.14	37,521.14	37,521.14
REAL ESTATE	5,800.00	5,848.13	6,109.82	6,165.16				37,248.88						
CAPITAL INVESTMENT		800.00	800.00											
DOUGLAS WILSON, Trustee		18,677.12			2,729.50									
WILSON HOLDING COMPANY	10,000.00	30,000.00	30,000.00	30,000.00	30,000.00				(4,318.86)	(2,318.83)	(1,461.79)			
SECURITIES	26,120.76	26,212.50	635,843.61	650,724.90	638,401.86	617,004.45	582,585.73	564,120.78	(564,025.50)	(563,930.22)	(564,888.96)	560,936.55	562,775.30	562,757.80
FOUNDATION FUND	20.00	40.00	50.00											
BUILDING & LOAN		1,767.50	2,269.25											
ADJUSTMENT ACCOUNT		1,749.75												
BOOK ACCOUNTS	28,307.27	19,752.03												
GOODWILL	12,500.00	12,500.00												
TOTAL ASSETS—	<u>194,769.66</u>	<u>205,023.62</u>	<u>757,736.09</u>	<u>808,835.19</u>	<u>503,262.76</u>	<u>810,544.94</u>	<u>817,484.16</u>	<u>815,751.00</u>	<u>807,344.52</u>	<u>797,748.79</u>	<u>754,112.11</u>	<u>753,936.23</u>	<u>752,100.26</u>	<u>754,440.32</u>
LIABILITIES and CAPITAL														
ACCOUNTS PAYABLE			1,934.25	54,939.97	54,339.97	54,205.72	52,205.72			83.35	2,253.70	2,106.70	1,601.70	1,061.70
NOTES PAYABLE								47,000.00	43,500.00	47,972.50	4,000.00	4,000.00	2,000.00	4,200.00
ADJUSTMENT ACCOUNT	3,352.89													
RESERVE FOR DEPRECIATION			4,005.31											
CAPITAL STOCK	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00	50,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00	200,000.00
Preferred														
Common														
SPECIAL RESERVE	37,274.04	37,187.19	36,762.19							1,500.00		25.00		
PROFITS IN SUSPENSE	28,307.27	19,752.03												
SURPLUS	75,835.46	98,084.40	117,734.34	156,395.22	151,622.79	159,039.22	17,978.41	21,451.00	16,544.52	892.94	558.41	504.53	1,198.56	1,878.62
SURPLUS BY APPRECIATION			547,300.00	547,300.00	547,300.00	547,300.00	547,300.00	547,300.00	547,300.00	547,300.00	547,300.00	547,300.00	547,300.00	547,300.00
TOTAL—	<u>194,769.66</u>	<u>205,023.62</u>	<u>757,736.09</u>	<u>808,835.19</u>	<u>803,262.76</u>	<u>810,544.94</u>	<u>817,484.16</u>	<u>815,751.00</u>	<u>807,344.52</u>	<u>797,748.79</u>	<u>754,112.11</u>	<u>753,936.23</u>	<u>752,100.26</u>	<u>754,440.32</u>

U. S. Board of Tax Appeals Div. 4 Docket 105054 Admitted
in Evidence Sep 24 1941 Petitioner's Exhibit Three.

Explanation of Items on Petitioner's Exhibit Three

1. Douglas Wilson, Trustee

This item appearing on the balance sheets of 1928 and 1931 represents advances to Douglas Wilson for the benefit of Douglas Wilson and other stockholders.

2. Wilson Holding Co.

This item appearing on the balance sheets of 1927, 1928, 1929, 1930 and 1931 represents in part advances to that company, and in part advances assumed by that company. The Wilson Holding Co. was a holding corporation owning real estate in Los Angeles County. The stock ownership of the Wilson Holding Co. was distributed among the children of Warren Wilson, Deceased, the father of Douglas Wilson.

3. Real Estate

This item as it appears on the balance sheets of 1932-1940 consists largely of real estate which the petitioner has accepted in cancellation of the account previously owed to it by the Wilson Holding Co.

4. Substantially all of the amounts appearing as Accounts Receivable and Notes Receivable on the balance sheets of 1930-1940 represent advances to stockholders plus some advances to the Wilson Holding Co. to enable it to pay Los Angeles City and County Property Taxes.

[156]

Petitioner's Exhibit Five
 CONSOLIDATED PRINTING & PUBLISHING CO.
 Operations subsequent to Consolidation

Year Ending June 30	Gross Operating Income	Income Before Officers' Salaries or Income Taxes	Income Before Income Taxes	Officers' Salaries ¹	Dividends Charged to Surplus ² "Class A" Pfd. "Class B" Pfd.	Common
1930	\$374,318.45	\$146,412.02	\$140,412.02	\$6,000.00	\$5,376.00	\$ 75,000.00
1931	414,315.82	183,907.52	177,907.52	6,000.00	7,839.00	125,000.00
1932	428,625.71	190,740.99	184,740.99	6,000.00	5,848.50	100,000.00
1933	359,275.60	151,195.17	145,195.17	6,000.00	3,045.00	100,000.00
1934	421,722.72	162,079.14	156,079.14	6,000.00	591.86	100,000.00
1935	336,090.80	78,095.55	72,095.55	6,000.00	28.00	100,000.00
1936	304,371.77	69,105.97	63,105.27	6,000.00		
1937	310,191.78	68,757.70	62,757.70	6,000.00	35.00	50,000.00
1938	241,928.76	55,885.57	49,885.57	6,000.00	42.00	56,250.00
1939	278,505.38	54,062.49	48,062.49	6,000.00		50,000.00
1940	260,795.69	54,285.80	48,283.80	6,000.00		37,500.00
Average	339,103.86	110,411.45	104,411.45	6,000.00	2,073.21	72,159.09

1—Paid to Wm. W. Roe, secretary-treasurer.

2—Dividends were not invariably paid out in the year of declaration. Payment was always made, however, during the ensuing fiscal period, if not before.

U. S. Board of Tax Appeals Div. 4 Docket 105054 Admitted
 in Evidence Sep 24 1941 Petitioner's Exhibit Five.

PETITIONER'S EXHIBIT SIX
Consolidated Printing & Publishing Co.
Consolidated Balance Sheets as of June 30, 1930, 1937, 1938 and 1939

	June 30, 1930	June 30, 1937	June 30, 1938	June 30, 1939
<u>Assets</u>				
Cash	\$ 24,609.59	\$ 9,406.84	\$ 38,909.92	\$ 35,836.29
Accounts Receivable (net)	86,058.32	100,408.95	51,663.40	54,014.98
Prepaid Expenses	2,592.19	2,398.93	3,022.98	628.62
Investments	1,335.90	2,225.00	2,199.50	2,110.25
Real Estate		75,000.00	75,000.00	75,000.00
Machinery	\$ 45,407.15	\$ 58,207.48	\$ 58,207.48	\$ 60,991.22
Equipment	10,012.43	14,723.27	14,796.33	14,756.43
Furniture and Fixtures	6,399.74	11,128.74	11,493.88	12,040.59
Automobile	691.05			
Total	62,510.37	84,059.49	84,497.69	87,788.24
Less Reserve for Depreciation	5,912.04	54,899.85	62,378.01	69,856.17
	56,598.33	29,159.64	22,119.68	17,932.07
Organization Expense	2,441.12			
Good Will	856,250.00	856,250.00	856,250.00	856,250.00
Total Assets	<u>\$1,029,885.45</u>	<u>\$1,074,849.36</u>	<u>\$1,049,165.48</u>	<u>\$1,041,772.21</u>
<u>Liabilities and Capital</u>				
Accounts Payable	\$ 12,030.03	6,327.43	12,989.82	18,723.55
Notes Payable		16,378.92	6,192.55	4,189.51
Dividends Payable	25,000.00			
Reserve for Taxes		11,122.48	6,481.58	11,000.00
Reserve for Commissions		6,845.34		
Sundry Reserves		2,025.40	7,094.78	7,060.15
Deferred Credits			1,536.30	1,536.30
Total Liabilities	<u>\$ 39,249.43</u>	<u>\$ 42,699.57</u>	<u>\$ 34,295.03</u>	<u>\$ 42,509.51</u>
<u>Capital Stock</u>				
Class "A" Preferred	80,600.00	300.00	300.00	500,000.00
Class "B" Preferred	500,000.00	500,000.00	500,000.00	300.00
Common	350,000.00	350,000.00	350,000.00	350,000.00
Earned Surplus				
Surplus by Appreciation	969,562.81	155,599.79	138,320.45	122,712.70
		26,250.00		26,250.00
Total Liabilities and Capital	<u>\$1,029,885.45</u>	<u>\$1,074,849.36</u>	<u>\$1,049,165.48</u>	<u>\$1,041,772.21</u>

U. S. Board of Tax Appeals Div. 4 Docket 105054 Admitted
in Evidence Sep 24 1941 Petitioner's Exhibit Six.

[158]

[Title of Circuit Court of Appeals and Cause.]

PETITION FOR REVIEW OF DECISION OF THE
UNITED STATES BOARD OF TAX APPEALSTo the Honorable Judges of the United States Circuit
Court of Appeals, for the Ninth Circuit.

Daily Journal Company, petitioner, hereby petitions this court to review the decision of the United States Board of Tax Appeals heretofore entered in the above entitled Board of Tax Appeals proceeding on May 12, 1942. Petitioner respectfully represents: [159]

I

This petition is filed pursuant to Internal Revenue Code Sections 1140-1142, 26 U. S. C. A. Sections 1140-1142 (1940).

II

NATURE OF CONTROVERSY

The present controversy relates to the proper determination of petitioner's Federal income tax for the calendar years 1936, 1937 and 1938 as well as whether or not petitioner is liable for personal holding company surtaxes for the years 1937 and 1938.

Respondent determined income tax deficiencies due from petitioner for the years 1936, 1937 and 1938 as follows:

1936	\$ 80.85
1937	409.50
1938	500.70

and also determined personal holding company surtax deficiencies due from petitioner for the years 1937 and 1938 as follows:

1937	\$5,616.98
1938	9,638.38

The Board of Tax Appeals by its said decision sustained respondent in its determinations, and petitioner hereby petitions for a review of the said decision of the Board of Tax Appeals. [160]

III VENUE

Petitioner filed its Federal income tax returns for the years 1936, 1937 and 1938 with the Collector of Internal Revenue for the Sixth District of California. Accordingly, petitioner is petitioning for a review of the said decision of the Board of Tax Appeals by this Circuit Court of Appeals for the Ninth Circuit.

Wherefore, your petitioner prays that this court review the said decision of the Board of Tax Appeals, reverse the said decision of said Board, and direct the entry of a decision by said Board in favor of petitioner, determining that neither deficiencies in Federal income taxes for the years 1936, 1937 and 1938 nor deficiencies in personal holding company surtaxes for the years 1937 and 1938 are due from petitioner.

Dated: August 4th, 1942.

Respectfully submitted

(s) Dana Latham

1112 Title Guarantee Building
Los Angeles, California

Attorney for petitioner.

State of California

County of Los Angeles

Dana Latham, being first duly sworn on oath, deposes and says:

I am the attorney for the petitioner in this proceeding. I have read the foregoing petition and am familiar with the contents thereof. The allegations of fact contained therein are true to the best of my knowledge, information and belief. This petition is not filed for purposes of delay and I believe that petitioner is justly entitled to the relief sought.

(s) Dana Latham

Subscribed and sworn to before me this 4th day of August, 1942.

(Seal)

(s) Isobel V. Hughes

Notary Public in and for the County
of Los Angeles, State of California.

My commission expires November 4, 1944

[Stamped]: Filed Aug. 6, 1942. United States Board
of Tax Appeals.

[162]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING OF PETITION FOR REVIEW

To the Commissioner of Internal Revenue, Washington,
D. C.

You are hereby notified that Daily Journal Company, petitioner in the above entitled Board of Tax Appeals proceeding is petitioning the United States Circuit Court of Appeals for the Ninth Circuit to review the Board of Tax Appeals decision heretofore rendered in the above entitled Board of Tax Appeals case on May 12, 1942. The petition [163] for review copy of which is attached hereto, and this notice of filing of petition for review are hereby served upon you.

Dated: August 4th, 1942.

(s) Dana Latham

1112 Title Guarantee Building
Los Angeles, California

Attorney for Petitioner

Service of this notice, together with the petition for review herein referred to, is acknowledged this 6th day of August, 1942.

(s) J. P. Wenchel,

J. P. WENCHEL, Chief Counsel
Bureau of Internal Revenue

By.....

[Stamped]: Filed Aug. 6, 1942. United States Board
of Tax Appeals.

[Title of Circuit Court of Appeals and Cause.]

DESIGNATION OF CONTENTS OF RECORD ON
APPEAL AND STATEMENT OF POINTS.

To B. D. Gamble, Clerk of the United States Board of
Tax Appeals, Washington, D. C.:

Petitioner in the above entitled proceeding hereby designates the following portions of the record, proceedings and evidence before the Board of Tax Appeals to be contained in the record on review before the Circuit Court of Appeals for the Ninth Circuit:

(1) Docket entries. [165]

(2) Petition and amended petition filed by petitioner with the Board of Tax Appeals.

(3) Answer to petition and answer to amended petition filed by respondent with the Board of Tax Appeals.

(4) Findings of fact and memorandum opinion of the Board of Tax Appeals.

(5) Decision of the Board of Tax Appeals.

(6) Deposition of Douglas W. Wilson as introduced in evidence at the hearing before the Board of Tax Appeals excluding therefrom Exhibits "B", "C" and "D".

(7) Rulings on respondent's objections with respect to Douglas W. Wilson's deposition.

The following objections by respondent to questions asked by petitioner of Douglas W. Wilson on his deposition were sustained by the Board of Tax Appeals:

1. Respondent's objection on page 8 of deposition (Tr.).

2. Respondent's first objection on page 9 of deposition (Tr.).

3. Respondent's first objection on page 17 of deposition (Tr.). [166]

The other objections by respondent to questions asked by petitioner of Douglas W. Wilson on his deposition were overruled.

(8) The following Exhibits introduced in evidence by petitioner at the hearing before the Board of Tax Appeals:

1. Petitioner's Exhibit "1".
2. Petitioner's Exhibit "2".
3. Petitioner's Exhibit 3.
4. Petitioner's Exhibit "5".
5. Petitioner's Exhibit 6.

(9) The following stipulation entered into by petitioner and respondent regarding the value of the services rendered by Douglas W. Wilson.

"Mr. Latham (for petitioner): Now, I might state that I have this to suggest with respect to that: A reasonable value of the services rendered by Douglas W. Wilson during the calendar years 1936, 1937 and 1938, as president of Consolidated Printing and Publishing Company, was not less than \$12,000 per year. In other words, had such a salary been paid during said years to Douglas W. Wilson by Consolidated Printing and Publishing Company, respondent would not contend that such a salary was excessive. In other words, what I am trying to do is indicate that we are in agreement except for the [167] fact that the salary was paid by a company other than Consolidated. Is that a correct statement of your position, Mr. Tonjes?

Mr. Tonjes (for respondent): If your Honor please, I agree to the first portion of that, but as to what the respondent would do under any given circumstances I am not prepared to admit.

Mr. Latham: I didn't intend to commit you.

Mr. Tonjes: I will admit that the services rendered by Douglas W. Wilson to the Consolidated Company were reasonably worth \$12,000 a year. I think that is the same thing that Mr. Latham said." (B. T. A. Tr. 33-34)

(10) The petition for review of decision of the Board of Tax Appeals and notice of filing of petition for review, together with proof of service of said petition and said notice of filing petition.

(11) This designation of contents of record on appeal and statement of points, together with proof of service thereof.

STATEMENT OF POINTS ON WHICH PETITIONER INTENDS TO RELY.

(1) The Board of Tax Appeals erred in entering decision for respondent. [168]

(2) The Board of Tax Appeals erred in failing to enter a decision for petitioner finding that petitioner neither was subject to any income tax deficiencies for the years 1936, 1937 or 1938, nor was subject to any personal holding company surtax deficiencies for the years 1937 or 1938.

(3) The Board of Tax Appeals erred in failing to find or conclude that during the years 1936, 1937 and 1938 petitioner was carrying on the business of managing and operating Consolidated Printing and Publishing Company.

(4) The Board of Tax Appeals erred in failing to find or to conclude that the \$12,000.00 annual salary paid by petitioner to Douglas W. Wilson in each of the years 1936, 1937 and 1938 was a reasonable and necessary busi-

ness expense within the meaning of the language of Section 23(a)(1) of the Revenue Acts of 1936 and 1938 and was deductible in determining petitioner's taxable net income for said years.

(5) The Board of Tax Appeals erred in sustaining respondent's first objection on page 17 of the deposition of Douglas W. Wilson (Tr.), namely, the objection to the following question asked by [169] petitioner of Douglas W. Wilson:

"Q. Why was that provision inserted in this contract between the Daily Journal Company and the Legal Publishing Company?"

Dated: August 7th, 1942.

Respectfully submitted,

DANA LATHAM

DANA LATHAM

1112 Title Guarantee Building

411 West Fifth Street

Los Angeles, California

Attorney for Petitioner

[Stamped]: Filed Aug. 17, 1942. United States Board of Tax Appeals.

[170]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING OF DESIGNATION OF CONTENTS OF RECORD ON APPEAL AND STATEMENT OF POINTS.

To the Commissioner of Internal Revenue, Washington,
D. C.:

You are hereby notified that Daily Journal Company, petitioner in the above entitled Board of Tax Appeals proceeding, is filing with the Clerk of the Board of Tax Appeals petitioner's designation of contents of record on appeal and statement of points. The said designation of contents of [171] record on appeal and statement of points, a copy of which is attached hereto, together with this notice of filing of the same, are hereby served upon you.

Dated: August 7th, 1942.

DANA LATHAM

DANA LATHAM

1112 Title Guarantee Building

411 West Fifth Street

Los Angeles, California

Attorney for Petitioner

Service of this notice, together with petitioner's designation of contents of record on appeal and statement of points, herein referred to, is acknowledged this 17th day of August, 1942.

J. P. Wenchel W

J. P. WENCHEL, Chief Counsel

Bureau of Internal Revenue

[Stamped]: Filed Aug. 17, 1942. United States Board
of Tax Appeals.

[172]

[Title of Board of Tax Appeals and Cause.]

CERTIFICATE

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 171, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praeipie in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 31st day of August, 1942.

[Seal]

B. D. Gamble, Clerk,
United States Board of Tax Appeals.

[Endorsed]: Transcript of Record. Filed September 5, 1942. Paul P. O'Brien, Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

[Title of Circuit Court and Cause.]

STATEMENT OF POINTS AND DESIGNATION
OF PARTS OF RECORD TO BE PRINTED

To the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit:

I

STATEMENT OF POINTS

Petitioner respectfully states that upon the hearing on its petition for review herein, petitioner intends to rely upon all of the points specified in its "Designation of Contents of Record on Appeal and Statement of Points," heretofore filed with the Clerk of the United States Board of Tax Appeals, which points are incorporated herein by reference.

II

DESIGNATION OF PARTS OF RECORD TO BE
PRINTED

Petitioner respectfully submits that all of the record on review, as certified to you, will be necessary for the consideration of the points upon which petitioner intends to rely. Accordingly, petitioner respectfully requests you to have printed the entire record on review in this case.

Dana Latham

Dana Latham

1112 Title Guarantee Building

Los Angeles, California

Attorney for Petitioner

[Title of Circuit Court of Appeals and Cause.]

In the United States Circuit Court of Appeals for the Ninth Circuit

Daily Journal Company, a Corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. No. 10240

AFFIDAVIT OF SERVICE

State of California

County of Los Angeles—ss.

Marilene Mattraw, being sworn says:

That she is a citizen of the United States and a resident of the County of Los Angeles; that she is over the age of eighteen years and is not a party to the above-entitled action; and that her business address is 411 West Fifth Street, Los Angeles, California.

That on the 10th day of September, 1942, she served the Statement of Points and Designation of Parts of Record to be Printed to which this affidavit is attached by placing a true copy thereof in an envelope addressed to the "Chief Counsel, Bureau of Internal Revenue, Washington, D. C."; by then sealing the said envelope, and by then depositing the same, with postage prepaid, in the United States Post Office at Los Angeles, California; and that there is delivery service by United States mail at the place so addressed.

Marilene Mattraw

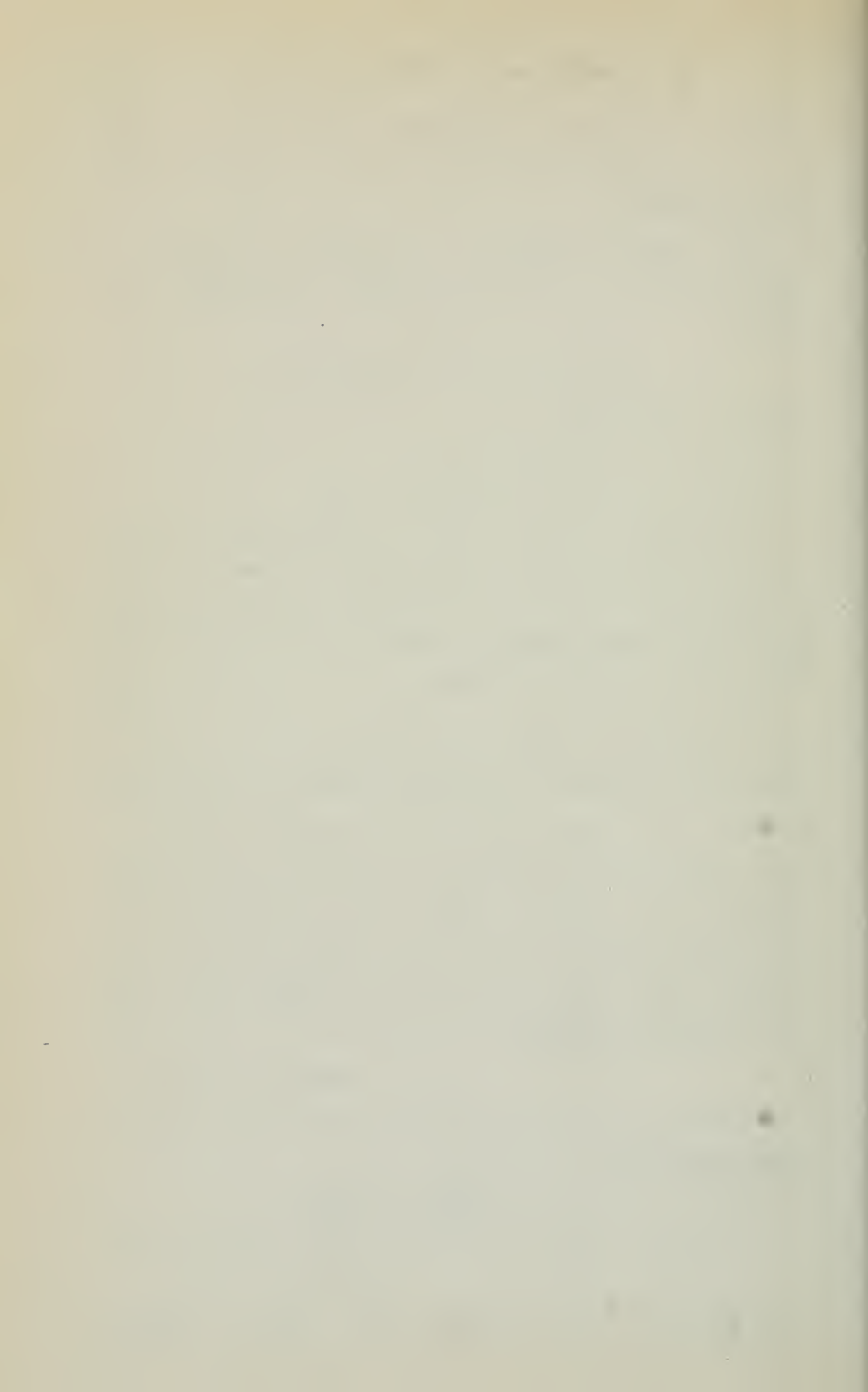
Subscribed and sworn to before me this 10th day of September, 1942.

[Seal]

Isobel V. Hughes

Notary Public in and for said
County and State

[Endorsed]: Filed Sep. 11, 1942. Paul P. O'Brien,
Clerk.



No. 10240

IN THE 2
United States Circuit Court of Appeals
FOR THE NINTH CIRCUIT

DAILY JOURNAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

LATHAM & WATKINS,

By DANA LATHAM,

RONALD C. ROESCHLAUB,

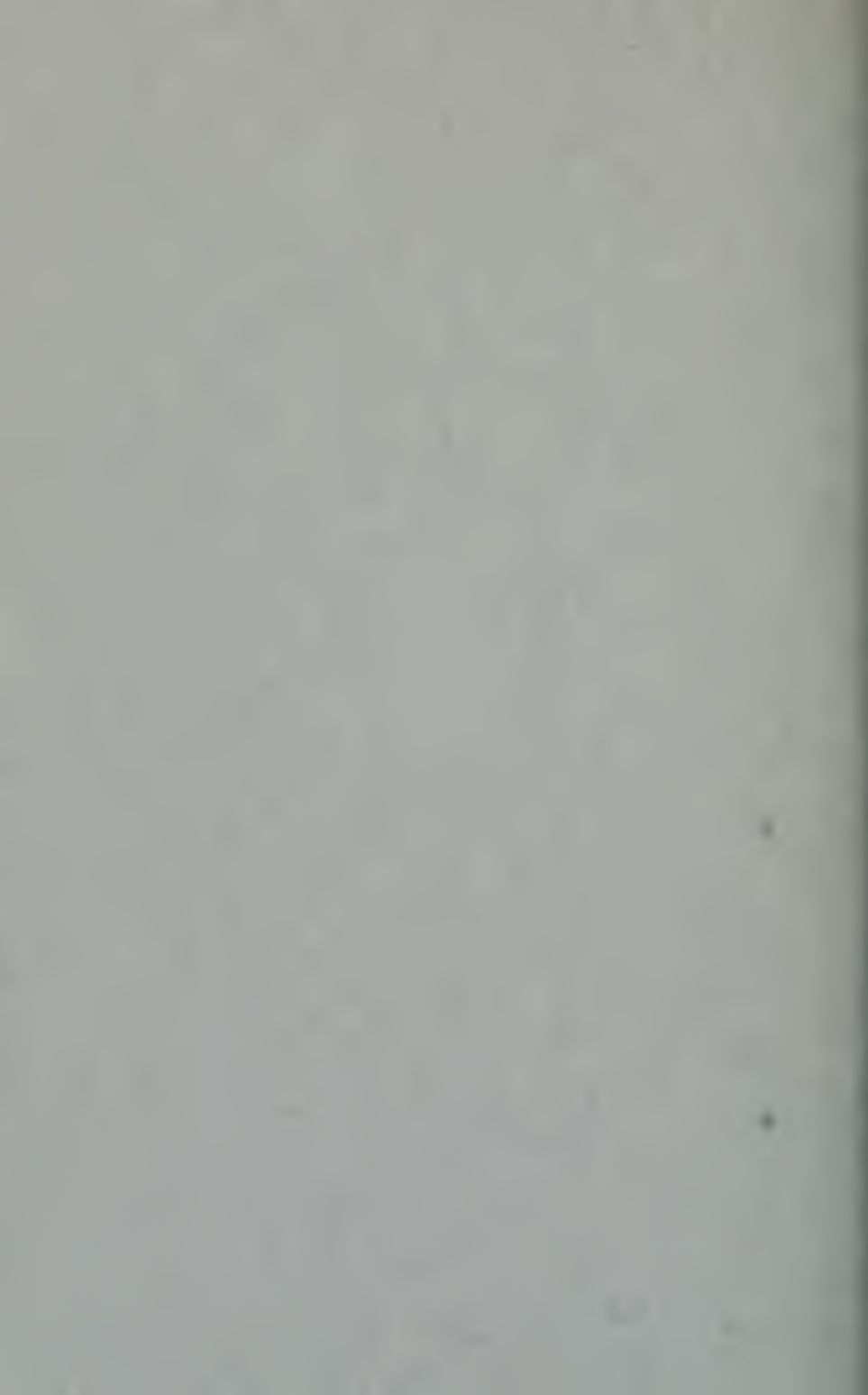
1112 Title Guarantee Building, Los Angeles,

Attorneys for Petitioner.

FILED

DEC 14 1942

PAUL P. O'BRIEN,
CLERK



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No. 10240

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

DAILY JOURNAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

Jurisdiction.

This petition for review involves deficiencies in Federal corporation income taxes for the years 1936, 1937 and 1938 in the total amount of \$991.05 and deficiencies in Federal personal holding company surtaxes for the years 1937 and 1938 totaling \$15,255.36. [Tr. 31.] The decision of the United States Board of Tax Appeals (now designated as the Tax Court of the United States and hereinafter referred to as the "Tax Court") fixing said deficiency was entered May 12, 1942. [Tr. 46.] This petition for review was filed August 6, 1942 [Tr. 150] pursuant to the provisions of Section 1142 of the Internal Revenue Code, 26 U. S. C. A. §§1140-1142 (1940).

Opinion Below.

The only previous opinion rendered in this cause is the memorandum opinion [unreported, Tr. 41-46] of the Tax Court.

Issues Involved.

(1) Is petitioner entitled to deduct in determining its net taxable income for the calendar years 1936, 1937 and 1938 the salary paid by it during said years to its president, Douglas W. Wilson.

(2) Under the circumstances here involved, is petitioner liable for personal holding company surtaxes for the years 1937 and 1938 in view of the fact that all of its income for said years was distributed either as dividends or salaries, and was duly tax paid by the recipients thereof.

A third question was raised before the Tax Court and related to the deductibility of a loss sustained by petitioner in connection with a bond issued by the Breakers Hotel. This issue was decided against petitioner by the Tax Court, but the decision with respect thereto is not before this Court for review.

Statutes and Regulations Involved.

(1) SALARY ISSUE.

(a) Section 23 of the Revenue Acts of 1936 and 1938 provides in part as follows:

“DEDUCTIONS FROM GROSS INCOME.

In computing net income, there shall be allowed as deductions:

(a) Expenses.—

(1) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

(b) Article 23(a)-6 of Regulations 94 and 101 issued under the Revenue Acts of 1936 and 1938 respectively provides in part as follows:

“Compensation for personal services.—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered * * *”

(2) PERSONAL HOLDING COMPANY SURTAX ISSUE.

(a) Section 351 of the Revenue Act of 1937 provides in part as follows:

“There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of \$2,000; plus

(2) 75 per centum of the amount thereof in excess of \$2,000.”

(b) Section 401 of the Revenue Act of 1938 provides in part as follows:

“There shall be levied, collected, and paid, for each taxable year, upon the undistributed Title IA net income of every personal holding company (in addition to the taxes imposed by Title I) a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of \$2,000; plus

(2) 75 per centum of the amount thereof in excess of \$2,000.”

Statement of Facts.

This proceeding was submitted to the Tax Court on the pleadings, the deposition of Douglas W. Wilson [Tr. 53-90], and certain exhibits containing pertinent statistical data introduced in evidence at the hearing. *The respondent introduced no evidence.*

Because of its importance, the testimony of petitioner's witness, Douglas W. Wilson, is printed in full in the transcript of record, pages 53-90.

The facts here involved are simple and may be summarized as follows:

(1) In 1893 one Warren Wilson acquired an unincorporated business operating in Los Angeles, California and called the Daily Journal Company which published a legal newspaper named the "Los Angeles Daily Journal." [Tr. 54, 55.] In 1895 this enterprise was incorporated under the name of Daily Journal Company, a California corporation, the petitioner herein. [Tr. 55.]

Warren Wilson was petitioner's president from its incorporation until the former's death in 1917. [Tr. 55.] At his death, and for some time prior thereto, Wilson received an annual salary of \$24,000.00 as petitioner's president. [Tr. 58.]

(2) In 1906, Douglas W. Wilson, Warren Wilson's son, entered the employ of petitioner as its circulation manager. [Tr. 54, 55.] In 1912, he became Vice-president and Assistant Manager. In 1917, upon his father's death, Douglas W. Wilson became petitioner's president, and has continued as such continuously to the present. [Tr. 56, 57.]

Since 1917, Douglas W. Wilson has devoted all his time to the management of petitioner's affairs [Tr. 57], and pursuant to appropriate corporate resolution has received from petitioner as president an annual salary of \$12,000.00. [Tr. 57, 58.]

(3) Between 1917 and 1929, petitioner's business more than doubled, its gross income increasing from about \$80,000.00 to more than \$187,000.00 in 1928. [Tr. 142, Petitioner's Exhibit One.]

(4) During the years immediately preceding 1929, the legal publishing business in Los Angeles became exceedingly competitive. [Tr. 60.] During this period, petitioner conducted approximately two-thirds of the legal publishing business in the Los Angeles area, but had several important competitors, including The Los Angeles News, The California Independent, The Los Angeles Review, and The Greater Los Angeles. Of the legal periodicals just mentioned, the Los Angeles News was second in importance to petitioner. [Tr. 60.]

(5) In 1929, the owner of the legal publishing company which owned The Los Angeles News, The Greater Los Angeles and a one-fourth interest in The California Independent approached petitioner and suggested a consolidation of the legal newspapers operating in the Los Angeles area. [Tr. 60.] After careful consideration by petitioner's stockholders and directors, a plan of consolidation was agreed to. [Tr. 61, 67.]

The consolidation plan contemplated the formation of a new corporation which was to acquire the publishing business of the various independent companies.

Said consolidation agreements appear in full in the transcript of record, pages 111-138. For the further information of the Court, the application filed on behalf of the new company with the California Corporation Commissioner for a Permit to issue and sell its stock appears in the transcript, pages 91-104. The consolidation plan as set forth in the agreements and petition just referred to was duly consummated. [Tr. 61-63.]

(6) The new company heretofore referred to was called "Consolidated Printing and Publishing Company." [Tr. 60.] Its Class A preferred stock was issued to the various periodicals heretofore referred to for tangible assets. Its Class B preferred and common stock was issued to said persons for subscription lists, good will and other intangibles. [Tr. 62-63 and 91-94.] Petitioner received 69% of the Class A preferred stock, 65% of Class B preferred, and 67% of the common stock. [Tr. 34.]

(7) Among others, the consolidation and the agreement providing therefor contained the following important features and provisions:

(a) The component companies, including petitioner, specifically agreed to render all possible aid to the new enterprise the consolidation agreement in this particular providing in part [Tr. 118]:

"It is hereby further covenanted and agreed that each of the said contracting parties and the stockholders of said contracting parties so far as the same can be bound by this agreement will use their best efforts and endeavors to further and promote the business of said new corporation."

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(b) It was specifically understood and agreed by all the parties that the new enterprise was to be managed by petitioner, acting through its president, Douglas W. Wilson. [~~Tr. 66, 88-90.~~] Had this not been agreed to, the consolidation would not have been effected. [~~Tr. 90.~~]

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Consolidated Printing and Publishing Company
(c) Consistent with the intent of the parties as heretofore set forth, it ~~was~~ specifically agreed that the new enterprise would pay no salary to any officer without the consent of all the directors. [~~Tr. 115, 129, 134, 65.~~] In this connection, the agreement provided in part [~~Tr. 115~~]:

"It is hereby further covenanted and agreed that the executive officers of said new corporation shall not charge or receive any salary for their services rendered to said corporation unless otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation."

(d) The various component enterprises acquired by the new corporation were operated as separate departments. [Tr. 73.] The various legal publications were not published under the name of Consolidated Printing and Publishing Company, but under their prior names. Consolidated Printing and Publishing Company is not known to the public; its name does not appear any place in the offices or plants of the enterprise; and it is not even listed in any Los Angeles Telephone Directory. It has no letterhead or billhead. [Tr. 71-73.]

At all times since the consolidation in 1929, petitioner's offices and plant have remained in the same location as prior to said consolidation. [Tr. 71.]

(8) Subsequent to the consolidation, the new enterprise has been managed by petitioner through the petitioner's president, Douglas W. Wilson. [Tr. 83.] For his services in these particulars, petitioner has paid to Wilson an annual salary of \$12,000.00. [Tr. 58, 66.]

The management services of Wilson are stipulated by the parties to be worth not less than \$12,000.00 a year. [Tr. 153-154.] In fact, they were reasonably worth \$18,000.00 a year. [Tr. 75.]

The new enterprise, namely Consolidated Printing and Publishing Company, has never paid Wilson any salary. [Tr. 66, 67.]

(9) Since the consolidation, petitioner's business has been the management of Consolidated, and the former stockholders and directors have met regularly and frequently to discuss and determine the policies to be followed in the conduct of Consolidated's business. Douglas W. Wilson in acting as president of Consolidated has at all times been proceeding under the express instructions and at the express direction of petitioner's directors. [Tr. 70, 77, 81, 82, 84, 86, 87, 88.]

(10) The stock of Consolidated received by petitioner in 1929 constituted petitioner's principal asset. [Tr. 69-70, 144-145.]

During the years here under review [Tr. 36-38] the income from Consolidated stock was prac-

tically the sole source of petitioner's income. During 1936, 1937 and 1938, income from sources other than Consolidated stock totaled 2.7%, .35% and 1.04%, respectively of petitioner's gross income. [Tr. 143, Petitioner's Exhibit Two.]

Since petitioner's business was the management of Consolidated and petitioner's principal asset and income came from Consolidated, petitioner's president, Douglas W. Wilson, devoted substantially all his time to the management of Consolidated. [Tr. 69.]

(11) Petitioner was not a mere investor in the stock of Consolidated, instead it was actively engaged in the management of said corporation. Upon cross-examination by counsel for respondent, Mr. Wilson testified in part as follows [Tr. 86, 87]:

“Q. The actual work and services performed by you in connection with the holding of the assets of the Daily Journal Company and the management thereof did not consume a great deal of your time, did it?

A. The assets of the old Journal?

Q. Of the Daily Journal Company, which it owned, during the years 1936, 1937 and 1938?

A. Other than the stock in the Consolidated?

Q. I mean all of the assets.

A. Oh, yes. It consumed all my time, including the stock of the Consolidated. That is our sole interest and practically the only asset we have is our stock in the Consolidated.

Q. All you have to do is to hold the stock, don't you? [101]

A. If you didn't manage the Consolidated properly, the Journal wouldn't have anything.

Q. But the fact is you weren't required to do that, were you?

A. Oh, definitely, by the stockholders of the Daily Journal Company. That is our sole interest. We have no other interest.

Q. Suppose you just sat by and collected the dividends, what would happen?

A. I don't think there would be any dividends, if we just sat by.

Q. But you could do it, if you just so chose?

A. I don't see how we could collect the dividends. I don't believe there would be any.

Q. The actual legal imposition of duties upon you was merely to hold the assets; isn't that correct?

A. No.

Mr. Latham: Just a minute. Will you read the question? I believe he has answered that a number of times, Mr. Tonjes.

Will you read the question?

(The question and answer were read.)

Mr. Latham: Oh, I have no objection.

Q. By Mr. Tonjes: Was the answer 'no'?

A. Yes.

Q. What else did you have to do?

A. To continue making a profit with those assets by [102] managing the Consolidated for the Daily Journal stockholders. That is the only source of income they have, and if not properly managed, would not be worth anything, and being a specialized business. I don't believe you could save those assets if they were mismanaged.

Q. Now, the \$12,000 salary which you received during the years, 1936, 1937 and 1938, was authorized by the board of directors in 1917?

A. Yes.

Q. In 1917 was the Daily Journal Company operating a newspaper?

A. Yes.

Q. And the corporation was then engaged in active business?

A. *Yes, the same as now.*" (Italics supplied.)

(12) During the years 1937 and 1938, petitioner pursuant to a consistent policy paid to its stockholders all the earnings received by it from Consolidated after deducting operating expenses. [Tr. 76.] Its earned surplus balances at the end of the years 1936, 1937 and 1938 were \$892.94, \$558.41 and \$504.53, respectively. [Tr. 144.]

(13) Petitioner's 1937 gross income was \$40,-851.75. [Tr. 142.] After paying the \$12,000.00 salary to Mr. Wilson, together with other operating expenses, petitioner paid out as dividends \$29,000.00. [Tr. 144.] In 1938, petitioner's gross income amounted to \$26,772.51. After paying to Mr. Wilson his salary of \$12,000.00, together with other operating expenses, petitioner distributed dividends of \$13,540.00 [Tr. 144.]

(14) Respondent disallowed as a deduction in determining petitioner's net income for the calendar year 1936, 1937 and 1938, \$10,000.00 of the \$12,-000.00 salary paid petitioner to its president, Douglas W. Wilson. Substantially all the tax deficiencies here in controversy result from such action.

In addition, respondent determined personal holding company surtaxes against petitioner for the years 1937 and 1938 on the theory that it had not distributed its net income to its stockholders. This action

was taken in spite of the fact that as heretofore shown it distributed all its income for said years either as salaries or dividends.

The Tax Court sustained respondent in the particulars specified. Its decision was apparently based on some theory that petitioner was endeavoring to improperly disregard corporate entities. [Tr. 44, 45.] This petition for review followed.

Specification of Errors.

[Tr. 154.]

(1) The Tax Court erred in failing to find or conclude that during the years 1936, 1937 and 1938 petitioner was carrying on the business of managing and operating Consolidated Printing and Publishing Company.

(2) The Tax Court erred in failing to find that the \$12,000.00 annual salary paid by petitioner to Douglas W. Wilson during each of the years 1936, 1937 and 1938 was a reasonable and necessary business expense within the meaning of the language of Section 23(a) (1) of the Revenue Acts of 1936 and 1938 and was deductible in determining petitioner's taxable net income for said years.

(3) The Tax Court erred in failing to enter a decision for petitioner finding that petitioner neither was subject to any income tax deficiencies for the years 1936, 1937 or 1938, nor was subject to any personal holding company surtax deficiencies for the years 1937 or 1938.

(4) The Tax Court erred in entering decision for respondent.

Petitioner's Contentions and Summary of Argument.

Petitioner contends:

(1) That the issue presented to this Court for review is not one of primary fact but rather is a question of ultimate fact, and may, therefore, be considered by this Court without regard to the ruling of the Tax Court.

(2) That the deductibility of items of expense paid by a stockholder of a corporation is dependent upon whether or not said stockholder occupies merely the role of a passive investor or is so actively engaged in the conduct of the enterprise that it constitutes said stockholder's business.

That if the stockholder is merely a passive investor, said items are not deductible. If he is doing more than merely what is necessary from an investment point of view, the contrary is true.

(3) That petitioner during the taxable years in controversy was in fact and law engaged in active business, namely, the management of Consolidated Printing and Publishing Company.

(4) That said active business could only be carried on by petitioner through its officers and employees of whom its present president, Douglas W. Wilson, was obviously one.

(5) That since petitioner was engaged in active business during the years under review, amounts paid by it to its president, in connection with the carrying on of its business, obviously constituted ordinary and necessary expenses and are obviously deductible in determining taxable net income.

(6) That the Tax Court, in denying the deduction claimed, admits that the question of reasonableness is not involved. Instead, it confused the issue by assuming that petitioner was seeking to disregard corporate entities.

(7) That the authorities cited by the Tax Court in its memorandum opinion are not in point as they all involved instances of passive investors. None of them involved cases of active business enterprises.

(8) That in the case at bar, petitioner actually distributed all its earnings either by way of salaries or dividends. The salaries paid by petitioner to its president cannot be recovered by petitioner and restored to surplus even though a portion thereof is disallowed as a deductible expense.

That the personal holding company surtax is a penalty tax intended to be asserted only where earnings have not in fact been distributed. It was never intended to be asserted in cases such as this where all earnings have in fact been paid out.

Outline of Argument.

- A. THE QUESTIONS HERE PRESENTED MAY BE CONSIDERED BY THIS COURT WITHOUT REGARD TO THE FINDINGS OF THE TAX COURT.
- B. ITEMS OF EXPENSE PAID BY A STOCKHOLDER IN CONNECTION WITH THE AFFAIRS OF A CORPORATION IN WHICH IT OWNS STOCK ARE DEDUCTIBLE IF THE STOCKHOLDER'S INTEREST IN SAID CORPORATION IS SO ACTIVE AS TO CONSTITUTE ITS BUSINESS.
- C. THE TAX COURT CLEARLY ERRED IN DISALLOWING AS A DEDUCTION THE \$12,000.00 SALARY PAID BY PETITIONER TO ITS PRESIDENT DURING THE YEARS IN QUESTION.
- D. REGARDLESS OF THE DEDUCTIBILITY OF THE SALARY CLAIMED, THE TAX COURT ERRED IN ASSERTING PERSONAL HOLDING COMPANY SURTAXES AGAINST PETITIONER FOR THE YEARS 1937 AND 1938.

Argument.

A. The Questions Here Presented May be Considered by This Court Without Regard to the Findings of the Tax Court.

We are clearly not here concerned with findings of primary fact. Accordingly, the Tax Court's conclusions are obviously not binding here.

The Tax Court's disallowance of the salary deduction claimed is not based on any theory that it is unreasonable in fact. The record shows that the services rendered by Mr. Wilson were eminently worth the \$12,000.00 claimed. It apparently is the Tax Court's and Respondent's contention, however, that said salary should have been paid by Consolidated Printing and Publishing Company. This involves the finding that petitioner was not in fact engaged in the operation and management of Consolidated, or, in other words, that petitioner's regular business was not the operation of Consolidated.

It is clear that the Tax Court's finding involved conclusions of law or at least the determination of a mixed question of law and fact. With respect to such issues, the Appellate Court is free to reach its own conclusion entirely independent of the finding of the Court below.

This precise situation was considered by the 7th Circuit Court in the recent case of *Marsch v. Commissioner*, 110 Fed. (2d) 423 (C. C. A. 7th, 1940). In that case the Tax Court denied to taxpayer a deduction for a loss sustained in connection with the operation of a racing stable, basing

its denial on the conclusion that petitioner was not engaged in business. Upon review, the Circuit Court reversed the Tax Court and said with respect to the latter's conclusions :

“The words ‘business regularly carried on by the taxpayer’ are not defined by the statute. In such a case the findings of the Board are not conclusive and where the ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact, it is subject to judicial review * * * (citations) * * * and it becomes the duty of the Court to decide whether or not the correct rule of law has been applied to the facts found.”

See also *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, 57 S. Ct. 569 (1939).

As a matter of fact, we do not feel that any claim has or will be made by respondent that the issues involved in this proceeding are not subject to full review by this Court.

B. Items of Expense Paid by a Stockholder in Connection With the Affairs of a Corporation in Which It Owns Stock Are Deductible If the Stockholder's Interest in Said Corporation Is so Active as to Constitute Its Business.

We are here concerned with the difference between a passive investor and one whose interest is so active as to amount to the conduct of a business. If the expenditure is connected with a trade or business, it is clearly deductible. If not, the contrary is true.

This principle was established by the leading case of *Foss v. Commissioner*, 75 Fed. (2d) 323 (C. C. A. 1st, 1935). There the taxpayer owned a majority stock interest in the American Blower Co. and had substantial investments in the B. F. Sturtevant Co. A minority stockholder of Blower Company filed suit charging taxpayer with waste of the company's assets, etc. The taxpayer incurred attorneys' fees and other expenses in connection with said litigation which he deducted as ordinary and necessary business expenses under provisions of prior revenue acts identical with those covering the years here under review.

The Commissioner disallowed said deductions and was sustained by the Tax Court. In reversing the Tax Court, the 2nd Circuit Court said, page 328:

"The line comes between those who take the position of passive investors doing only what is necessary from an investment point of view and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business."

This principle has been clearly recognized and followed by the Courts.

Helvering v. Highland, exec., 124 F. (2d) 556
(C. C. A. 4th, 1942);

Kane v. Commissioner, 100 F. (2d) 382, C. C. A.
2d, 1938;

Marsch v. Commissioner, supra;

See:

Stephen Hexter v. Commissioner, 47 B. T. A. No.
69 (1942).

This line of distinction has been recognized by the Supreme Court.

See:

Higgins v. Commissioner, 312 U. S. 212, 217, 61
S. Ct. 475, 478 (1941).

The *Highland* case, *supra*, is especially worthy of careful consideration. There the decedent left a substantial estate which included the capital stock of several land companies and a majority of the Class A common stock in the Clarksburg Publishing Company which published two papers. The decedent by his will authorized the executors to carry on any business or financial affairs in which the decedent might be interested at the time of his death "as fully and to the same extent as I could or might do if still living." Decedent's executor became president of the Clarksburg Publishing Company and had directed the policies of the newspapers published by said corporation. Said executor devoted practically all his time to the management of the real estate companies and the Clarksburg Publishing Company. Dividends received from the Clarksburg Publishing Company constituted a substantial part of the estate's income.

The estate became involved in litigation with respect to its interest in the Clarksburg Publishing Company and certain of the land companies, etc. It incurred other expenses with respect to claims against the estate, office expenses, etc. These various items were claimed as deductions by the estate in determining its gross income during the years under review. All were disallowed by the Commissioner. The tax Court reversed the Commissioner with respect to certain of said deductions and in particular allowed those pertaining to the management of the Clarksburg Publishing Company and various land companies. The Commissioner petitioned the Circuit Court for review.

The Court in affirming the decision of the Tax Court cited with approval the *Foss* case, *supra*, and said:

“* * * clearly the taxpayer was not in the role of a passive investor, a mere conservator of property or a normal liquidator of an estate * * *

“Rather we believe that the estate, by virtue of its holdings in several real estate companies, was actively engaged in the real estate business and even more actively in the newspaper business. All of the evidentiary factors which we have previously mentioned in this opinion point to such a conclusion.

“We agree with the Board that the suits involved in this case were connected with the carrying on of the business of the estate and not with its mere conservation or liquidation * * *”

It would be difficult to find a case more squarely in point here than the one just referred to. In connection therewith the following should be noted:

(1) The net income of the estate in the *Highland* case was computed in exactly the same fashion, so

far as expenses are concerned, as that of petitioner herein, and as the net income of an individual would be computed.

(2) The estate in carrying on the publishing business as a stockholder of a corporation could act only through the estate's executor. In the instant case, petitioner in carrying on the business of Consolidated could only act through its president to whom it paid a salary.

(3) If the *Highland* estate was carrying on the publishing business under the facts heretofore specified, petitioner herein was clearly carrying on the same type of business in conducting the affairs of Consolidated Printing and Publishing Company.

This Court has itself specifically recognized the test of "Is the taxpayer doing only what is necessary from an investment point of view?"

Miller v. Commissioner, 102 Fed. (2d) 476 (C. C. A. 9th, 1939).

There this Court cited the *Foss* case, *supra*, as authority for the following statement:

"The Courts have held that where a man takes an active part in the management of an enterprise in which he has investments, his activities amount to the carrying on of a trade or a business, but they have drawn the line between such cases and those where the activities of the party are merely looking after investments and doing only what is necessary from an investment point of view."

C. The Tax Court Clearly Erred in Disallowing as a Deduction the \$12,000.00 Salary Paid by Petitioner to Its President During the Years in Question.

(1) Petitioner was not a passive investor so far as Consolidated was concerned, but was engaged in active business and said business consisted of the management of Consolidated.

The Tax Court in its memorandum opinion said [Tr. 44]:

“* * * we cannot agree with petitioner’s view that its business was that of operation and management of Consolidated,”

but assigned no reason for its conclusion in this regard. With all due respect to the Tax Court, we submit that its finding is clearly erroneous and totally without basis in fact or law.

Every fact and circumstance here involved indicates that the sole business of petitioner was the management and operation of Consolidated. The original Consolidation agreement, heretofore referred to, specifically required petitioner to devote its best efforts to the furtherance of Consolidated’s business. [Tr. 118.] It was at all times specifically contemplated that petitioner would operate Consolidated through its president, Douglas W. Wilson. Petitioner’s stockholders and directors directed Wilson to become president of Consolidated and to operate Consolidated. *This was the only way by which petitioner could carry out its contractual obligations.*

The testimony of Mr. Wilson printed in full in the transcript, pages 63 to 90, is conclusive with respect

to the matters here in controversy. Should there be any doubt that petitioner's business was the management of Consolidated, we respectfully suggest that the Court read said testimony in full.

It would be difficult to conceive of a clearer example of the conduct of an active business than that here involved. The facts of this case, it is submitted, fall squarely within those involved in the case of *Helvering v. Highland*, *supra*. All that was said there is applicable here.

(2) The Tax Court confused the issue here involved.

The Tax Court's memorandum opinion [Tr. 44 to 46] indicates that it did not grasp the real issue, namely, whether we were here concerned with the case of a passive investor or the active conduct of a business.

Apparently the Tax Court thought that petitioner was asking it to disregard corporate entities. This is indicated by the following excerpts from the Tax Court's memorandum opinion.

"The circumstances and facts disclosed by the record, in our opinion—and we so hold and determine—show that the petitioner and Consolidated are distinct and separate corporate entities and that they are such may not be disregarded or ignored. * * *" [Tr. 44.]

Again the Tax Court said in its opinion:

"A clear statement of the law touching the setting aside or disregard of corporate entities and citation of numerous authorities bearing on the subject are given in Inland Development Co.

v. Commissioner, 120 Fed. (2d) 986 (C. C. A. 10), decided in June, 1941.” [Tr. 45.]

It is perfectly obvious that petitioner is not and never did contend that corporate entities should be disregarded. It has never even been remotely suggested that such procedure should be followed. The Tax Court has apparently misconceived the real issue.

(3) The authorities cited by the Tax Court in its memorandum opinion are not in point.

In this connection the Tax Court said in its opinion [Tr. 43],

“That the \$12,000.00 salary payment by petitioner * * * in each of the taxable years * * * was not an ordinary expense of petitioner in the carrying on of its business * * * is virtually conceded by petitioner’s counsel, who at the hearing herein, in part, stated: ‘With regard to the salary issue, I might add that this is not the ordinary salary case by any manner or means. I know of no case on the books that is any where close to the issue that we have.’”

The Court’s observation in this respect was obviously unjustified. Its irrelevance must be clear. By said remark counsel only intended to make it clear that we were not dealing with a fact case in which an *unreasonable* salary was involved.

It is unnecessary to here review all the authorities referred to by the Tax Court in its opinion. We trust it will be sufficient to say that counsel for petitioner has read them all with care. We respectfully assert that not one is in point. Our views in this

particular may be best illustrated by examining the first authority referred to by the Tax Court, namely, the decision of said Tax Court in the case of *W. M. Ritter Lumber Co.*, 30 B. T. A. 231 at 272. There the taxpayer corporation sold certain of its products through an English Corporation. Said taxpayer paid certain employees of said English corporation a bonus and claimed the right to deduct said payments in determining taxable income. *The persons to whom said bonuses were paid were not employees of the taxpayer.* No claim was made that the business of the taxpayer consisted of the operation of the English corporation.

The Tax Court in denying the deduction claimed said:

“Clearly such expenditures were purely gratuities and did not constitute deductible ordinary and necessary business expenses of the Ritter Co. * * *.”

It would be difficult to find a case less in point than the one just cited. Its use by the Tax Court as an authority for its decision in the case at bar is further proof of the fact that the Tax Court totally failed to understand the real issue under consideration.

D. Regardless of the Deductibility of the Salary Claimed, the Tax Court Erred in Asserting Personal Holding Company Surtaxes Against Petitioner for the Years 1937 and 1938.

The respondent, as a result of disallowing \$10,000.00 of the \$12,000.00 salary claimed as a deduction in each year, increased taxable income by said amount disallowed. It then found that said income had not been distributed. and imposed the highly punitive personal holding company surtax which amounts to sixty-five and seventy-five per cent in addition to the regular income tax on the amounts disallowed. This action was taken in spite of the obvious fact that the corporation had *actually* distributed all its earnings during the years under review. As heretofore pointed out in the statement of facts, the petitioner's records show that it accumulated no earned surplus during the years under consideration. Even if respondent was right in disallowing the salary claimed, it could not be recovered from petitioner's president who has, himself, paid a tax thereon. Accordingly, under no circumstances could petitioner obtain any surplus out of which the \$10,000.00 disallowed each year could possibly be distributed.

All these facts are crystal clear. Nevertheless, respondent proposes to assert personal holding company surtaxes for 1937 and 1938 in the amount of \$15,255.36. A more inequitable result where a taxpayer has obviously acted in good faith could scarcely be imagined.

The personal holding company surtax was obviously intended to be asserted only where earnings were not distributed. It was never intended to be asserted in situations such as the present.

The courts have the power and duty to declare that a thing presumably within the letter of a statute is nevertheless not subject thereto because not within its spirit or the intention of its makers. This power has been used by the courts to prevent abuse of statutory provisions by taxpayers, see

Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266 (1939),

and to prevent an unjust and unintended application of the taxing statute.

Pembroke Realty & Securities Corporation v. Commissioner, 122 F. (2d) 252 (C. C. A. 2nd, 1941).

In the last named case a corporation with its capital impaired and accordingly unable to pay out dividends had a large gain in its taxable year. Shortly before the end of the taxable year the assets of the corporation were distributed in complete liquidation, the corporation reserving only sufficient cash to pay the normal income taxes and cost of liquidation. The Commissioner assessed a personal holding company surtax deficiency on the ground that none of the income was distributed. Without question this situation came within the precise language of the personal holding companies surtax statute. The Tax Court sustained the Commissioner. The Second Circuit Court

reversed the Tax Court's decision. The Court explained the broad ground upon which it rested its decision in the following language:

"It is within the power of the courts to declare that a thing which is within the letter of the statute is not governed by the statute because not within its spirit or the intention of its makers (citations). We think this principle justifies the holding that Pembroke, which distributed all of its current income in complete liquidation, was not subject to the surtax provided by Section 351."

This principle that a statute should not be applied where the particular situation is without doubt outside the spirit of the statute and the intention of the legislators and where the inclusion of the particular situation within the statute would lead to a gross injustice is not a new principle of law. Instead it is a general rule which has been long recognized by our Supreme Court.

Lau Ow Bew v. United States, 144 U. S. 47, 12 S. Ct. 517 (1892);

Rector, etc. of Holy Trinity Church v. United States, 143 U. S. 457, 12 S. Ct. 511 (1892).

Petitioner respectfully submits that if there was ever a case in which this equitable power should be invoked it is the present case, and that irrespective of the ruling of the Tax Court with respect to the salary deduction, it should not be liable for personal holding company surtaxes for the years 1937 and 1938 on any amount.

Conclusion.

In conclusion, petitioner respectfully submits:

(1) That the salary paid its president during the years 1936, 1937 and 1938 is properly deductible in determining petitioner's taxable net income.

(2) That is no event should personal holding company surtaxes be asserted against petitioner for the years 1937 and 1938.

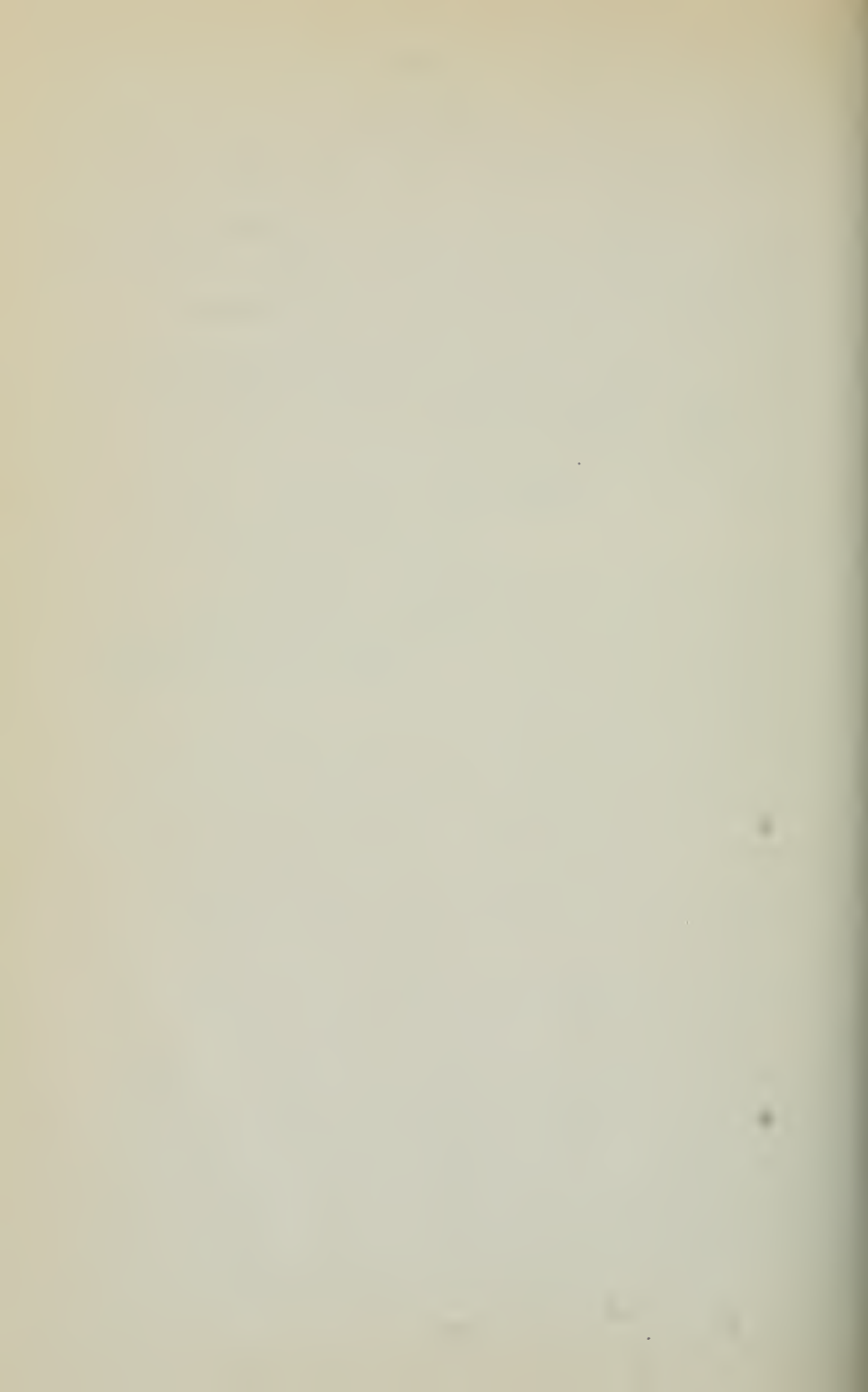
Respectfully submitted,

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No. 10240

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

DAILY JOURNAL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**ON PETITION FOR REVIEW OF THE DECISION OF THE TAX
COURT OF THE UNITED STATES**

BRIEF FOR THE RESPONDENT

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FILED

JAN 13 1947

**PAUL P. O'BRIEN,
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*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX
COURT OF THE UNITED STATES*

BRIEF FOR THE RESPONDENT

OPINION BELOW

The only previous opinion in this case is the memorandum opinion of the United States Board of Tax Appeals (R. 31-46), which is not reported.

JURISDICTION

The petition for review herein involves deficiencies in corporate income taxes in the aggregate amount of \$991.05 for the taxable years 1936-1938 and personal holding company surtaxes in the aggregate sum of \$15,254.46 for the years 1937 and 1938 as asserted by the Commissioner of Internal Revenue in notice of deficiency mailed July 3, 1940. (R. 7-17, 31.) Within ninety days thereafter and on October 2, 1940, the

taxpayer filed a petition with the Board of Tax Appeals for a redetermination of those deficiencies under the provisions of Section 272 of the Internal Revenue Code. (R. 2-17.) The final order and decision of the Board of Tax Appeals, sustaining the deficiencies in question, was entered on May 12, 1942. (R. 46.) The case is brought to this Court by petition for review filed August 6, 1942 (R. 148-150), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code. As of October 22, 1942, by Section 504 of the Revenue Act of 1942, the name of the Board of Tax Appeals was changed to The Tax Court of the United States. Although the decision of the Board and the petition for review were both filed prior to that date, since the record was prepared and printed subsequent thereto by the clerk of that tribunal he captioned the record as "Upon Petition to Review a decision of the Tax Court of the United States".

QUESTIONS PRESENTED ¹

(1) Whether the taxpayer is entitled, under Section 23 (a) (1) of the Revenue Acts of 1936 and 1938, to deduct the full amounts paid to its president, Douglas W. Wilson, as reasonable compensation for services rendered by him to another corporation during each of the taxable years 1936, 1937 and 1938.

¹ A third question—whether the taxpayer sustained a deductible loss in 1938 upon the exchange of a bond for shares of capital stock of different corporations, respectively, under the provisions of Section 112 (b) (5) of the Revenue Act of 1938—was decided by the Board adversely to the taxpayer (R. 45-46), but the taxpayer has abandoned that issue (Br. 2).

(2) Whether the taxpayer is liable, under Sections 351 (a) and 401 (b) of the Revenue Acts of 1936 and 1938, for personal holding company surtaxes for the years 1937 and 1938.

Determinative of this is the question whether any portion of the amounts which the taxpayer paid its president and claimed as a deduction as compensation paid to an officer of the corporation, but portions of which were disallowed by the Commissioner during the years 1937 and 1938, constituted distribution of dividends in those years.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations involved are set forth in the Appendix, *infra*, pp. 30-36.

STATEMENT

The facts as shown by a deposition, several exhibits and a stipulation (R. 53-147), were adopted by the Board of Tax Appeals by reference as its findings of fact (R. 31) and were summarized sufficiently for a determination of the issues herein as follows (R. 31-37):

The taxpayer's income tax returns for the taxable years were filed with the Collector at Los Angeles, California. (R. 31.)

In 1893, one Warren Wilson acquired an unincorporated business called the Daily Journal Company which published the Los Angeles Daily Journal, a California daily newspaper which specialized in legal news. In 1895, the enterprise was incorporated under the laws of the State of California as the Daily Journal Com-

pany, which corporation is the taxpayer herein. (R. 32.)

Warren Wilson acted as president of the corporation from the date of its incorporation to the date of his death, in 1917, at which date and for several years prior thereto he, as the president thereof, received a salary of \$24,000 a year. (R. 32.)

In 1917, after the death of Warren Wilson, Douglas W. Wilson, a son (hereinafter referred to as Wilson), who had been connected with the company for a number of years, was elected president thereof and the salary of the president was by resolution of the stockholders reduced from \$24,000 to \$12,000 a year, at which it has continued, no further corporate action being taken with respect thereto. During the taxable years, 1936-1938, inclusive, taxpayer paid no officers' salaries to anyone except Wilson. (R. 32.)

During the year 1929, and for several years prior thereto, there was serious competition in the legal news and advertising business, in which taxpayer was engaged, between it and the Los Angeles News, the California Independent, the Los Angeles Review and the Greater Los Angeles, which unfavorably affected the income of all these newspapers. At that time the Daily Journal Company, the taxpayer, was doing about two-thirds of the available legal publishing business in Los Angeles. (R. 32.)

The matter of forming a new corporation was discussed by the representatives of the several newspapers mentioned, resulting in 1929 in the incorpora-

tion of the Consolidated Printing & Publishing Company, frequently herein called the "Consolidated", the capital stock of which was issued in exchange for the assets, good will and business of the concerns forming the Consolidated. In connection with the formation of the new corporation, the Consolidated, the parties interested and involved executed certain written agreements indicating therein the general tenor of the proposed consolidation and the interests of the respective parties in the consolidated enterprise. (R. 33.)

The parties to the consolidation understood and agreed that Wilson, who was the president of the Daily Journal Company, would become and continue to act as the president and general manager of the Consolidated. The understanding and agreement described and the execution of the duties imposed on Wilson thereby existed and were discharged by Wilson throughout the years 1936, 1937 and 1938. (R. 33.)

After the organization of the Consolidated was completed, the newspapers then composing the same, but continuing under their own names, were printed and published by the Consolidated and this situation existed throughout the years 1936, 1937 and 1938. (R. 33.)

The stock of the Consolidated Printing & Publishing Company in 1929 was issued in amounts indicated in the schedule below and in the taxable years was held as also shown therein (R. 34):

Name of Stockholder	Shares Received upon Consolidation in 1929			Shares Held In 1936, 1937 and 1938		
	"Class A" Pfd.	"Class B" Pfd.	Common	"Class A" Pfd.	"Class B" Pfd.	Common
L. A. Journal Group: Daily Journal Company.....	551	3258	2340		3258	2340
L. A. News Group:						
Legal Publishing Company.....	161	1086	780			
C. A. Page.....					387	560
Marietta Page.....					193	
Chas. A. Page, Jr.....					193	
G. V. Allen.....					157	110
Ethel Allen.....					156	110
Calif. Independent Group:						
Dan W. Green.....	85	469	272		469	272
Marie McManus.....	3	63	36		63	36
Elmar Riggins.....		62	36			
Forrest A. Riggins.....					62	36
Kathryn G. Lawson.....		62	36		62	36
Qualifying shares:						
Douglas W. Wilson.....	1			1		
Wm. W. Roe.....	1			1		
A. A. McDowell.....	1			1		
C. A. Page.....	1					
G. V. Allen.....	1					
Walter F. Haas.....	1					
Frank P. Doherty.....				1		
Treasury Stock.....				7		
	806	5000	3500	11	5000	3500

1. All but qualifying shares of "Class A" preferred stock were retired in 1932 and 1933 pursuant to the stock contract.

The Legal Publishing Company was owned by C. A. Page and G. V. Allen who in 1930 took over that corporation's stock in Consolidated Printing & Publishing Company. Thereafter, in December, 1930, they dissolved the Legal Publishing Company. Subsequently they have distributed part of their holdings to members of their respective families. (R. 34.)

The capital stock of the Daily Journal Company, the taxpayer, was owned in the years and in the amounts shown in the schedule below (R. 35):

Name of Stockholder	Shares held on May 3, 1917 ¹	Shares held on July 1 1929 ²	Shares held on March 20, 1933 ³		Shares held during 1936, 1937 and 1938	
			<i>Pfd.</i>	<i>Com.</i>	<i>Pfd.</i>	<i>Com.</i>
Warren Wilson.....	5					
Wm. W. Roe.....	5	*5	*15	*5	*15	*5
Wm. W. Roe, Trustee ⁴	475					
Mrs. C. M. Wilson.....	5	*5				
Douglas W. Wilson.....	10	65	1050	350	1050	350
Walter F. Haas.....		*5	*15	*5	*15	*5
Cora Wilson Prewett.....		70				
Clara Wilson Tousley.....		70	210	70	210	70
Lois Wilson Kinney.....		70				
Florence Wilson McDowell.....		70	210	70	210	70
Grace Wilson McLean.....		70				
Irma Wilson Dorland.....		70				
	500	500	1500	500	1500	500

¹ May 3, 1917, shortly after the death of Warren Wilson, Douglas W. Wilson was elected President of Daily Journal Company.

² The consolidation in 1929 was effective as of July 1, 1929.

³ On March 20, 1933, Daily Journal Company capitalized \$150,000 of earned surplus and issued a preferred stock dividend of 1500 shares of 17% preferred stock.

⁴ Trustee for Warren Wilson, Deceased.

*Qualifying Shares.

The agreement between the taxpayer and the Legal Publishing Company, entered into on June 20, 1929, relative to the creation of the Consolidated, provided in part (R. 35-36):

It is hereby further covenanted and agreed that the executive officers of said new corporation shall not charge or receive any salary for their services rendered to said corporation unless otherwise ordered by the affirmative vote of all of the members of the Board of Directors of said new corporation.

* * * * *

It is hereby further covenanted and agreed that each of the said contracting parties and the stockholders of said contracting parties so far as the same can be bound by this agreement, will use their best efforts and endeavors to further and promote the business of said new corporation.

During the taxable years 1936, 1937 and 1938, the assets of the taxpayer consisted principally of capital stock of the Consolidated Printing & Publishing Company. Taxpayer had some cash, accounts and notes receivable, and real estate, none of which required any considerable time or service of Wilson with respect to the management thereof, and reasonable compensation for which was \$2,000 per year, which is not controverted and was allowed as a deduction by the Commissioner in computing taxpayer's net taxable income. Practically all the taxpayer's income was received from the Consolidated Printing & Publishing Company in the form of dividends on the stock which the taxpayer owned therein. (R. 36.)

The taxpayer in the taxable years owned no printing presses and did not actually print and publish any newspaper. The Los Angeles Daily Journal, however, was printed and published by the Consolidated for the Daily Journal Company. (R. 36.)

Wilson, as contemplated by the agreements heretofore referred to and pursuant to instructions of the stockholders and directors of the taxpayer, devoted practically all his time during the taxable years to the operation and management of the Daily Journal Company and the other papers constituting the Consolidated, the fair value of the services so rendered to the Consolidated being, as agreed by the parties hereto, not less than \$12,000 per annum, which amount was paid by taxpayer to Wilson in each of the taxable years. No compensation was paid to Wilson by the Consolidated for his services in managing its affairs. (R. 36-37.)

After the incorporation and organization of the Consolidated, the offices of the Daily Journal and of its president, Wilson, and of the Consolidated, were in the same building and in the same room. The name, Consolidated Printing and Publishing Company, does not appear any place at the offices nor has the Consolidated ever had any letterheads or billheads. So far as the general public is concerned, the newspapers forming or constituting the Consolidated are still published as before the consolidation. (R. 37.)

At no time during the taxable years did Wilson own any Consolidated stock, other than one qualifying share of Class A. (R. 37.)

In computing taxpayer's taxable net income for the taxable years, \$10,000 of the \$12,000 paid Wilson by taxpayer each year was disallowed by the Commissioner. (R. 37.)

During each of the years 1937 and 1938, the taxpayer paid to its stockholders all dividends received from Consolidated, after deducting operating expenses, as evidenced by the earned surplus balances at the end of 1937 and 1938 of \$558.41 and \$504.53, respectively. (R. 37.)

During the years 1937 and 1938, taxpayer had gross incomes of \$40,851.75 and \$26,772.51, respectively, and after paying in each of those years \$12,000 as salary to Wilson and other operating expenses, the taxpayer paid out in 1937 and 1938 dividends totaling \$29,000 and \$13,500, respectively. (R. 37.)

Upon the basis of the foregoing facts the Board, affirming the Commissioner's determination, denied

the deductions for the excessive salaries claimed and the dividends paid credit for the salaries disallowed (R. 41-45), and thereupon entered its decision accordingly (R. 46). From the decision so entered the taxpayer petitioned this Court for review. (R. 148.)

SUMMARY OF ARGUMENT

(1) The statute and regulations do not allow deductions, as ordinary and necessary expenses, for amounts paid by a corporation to its officer as compensation for personal services actually rendered by him directly to another corporation during the taxable year. The Board found that the amounts representing the value of the services rendered for another were properly disallowed by the Commissioner, and determined, upon the evidence, that the portion of the salaries representing a reasonable compensation commensurate with the services actually rendered to taxpayer were allowable. This Court has held that if the salaries paid by a corporation to its officer exceeded the reasonable value of the services actually rendered to it, the corporation may deduct only such amount as found by the Board to be the reasonable value of the services rendered.

There is nothing in the statutes or regulations to indicate that the claimed salaries paid by taxpayer may be deducted by it in connection with the carrying on of another's trade or business. Neither do the facts show that the devotion of the taxpayer's president of practically all his time to the management and operation of Consolidated constituted the *taxpayer's* carrying on the business of the latter. Taxpayer had substantially no more control over Consolidated than did

the other stockholders, all of whom, including taxpayer, were merely indirect beneficiaries, solely through dividends paid them by Consolidated in proportion to their stockholdings, of the increased profits resulting from Wilson's participation in the conduct of the business affairs of Consolidated during the taxable years herein. It cannot be said, therefore, that the taxpayer's payments to Wilson for his services rendered to Consolidated to produce profits for taxpayer and the other stockholders in proportion to their stockholdings, constituted ordinary and necessary expenses paid or incurred in carrying on *taxpayer's* trade or business.

Moreover, since the two corporations were admittedly separate entities and their businesses were separate, distinct and materially different in many respects, there is no basis for the contention that the salaries in question, paid for services rendered to another corporation, constituted taxpayer's expenses of doing business.

(2) No part of the amounts taxpayer paid its president during 1937-1938 constituted a distribution of dividends, and therefore taxpayer is liable for personal holding company surtaxes for those years. Even if the disallowed portions of the excess salaries be considered as dividends, taxpayer is nevertheless not entitled to any dividend-paid credits in the computation of its tax liability for those years. This is true because the claimed distribution was not "pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class", as specifically required by the terms of

the statutes. The amounts in question were paid as salaries and not as dividends, and there is no showing that any portion thereof was authorized as a dividend by taxpayer's directors or stockholders, or that any of the stockholders other than Wilson participated in the payments.

ARGUMENT

I

The taxpayer is not entitled to deduct as ordinary and necessary business expenses for the taxable years 1936-1938 the amounts paid its president, and disallowed by the Commissioner, as compensation for personal services actually rendered by him directly to another corporation during each of those years

The taxpayer's principal asset from 1929 to the taxable year 1938, inclusive, was approximately two-thirds of the outstanding capital stock of Consolidated, the dividends from which constituted almost its sole source of income during the taxable years 1936-1938 involved herein; it owned no printing presses, printed and published no newspapers, having been during that period almost wholly a holding company; the \$2,000 yearly portion of the entire salaries which it paid its president was concededly a reasonable compensation for the small portion of his time devoted to the taxpayer's slight business activities; and the \$12,000 annual salary paid the president by the taxpayer during each of those years constituted the fair value² of his time and services devoted almost entirely

² It is stipulated that President Wilson's services to Consolidated were reasonably worth not less than \$12,000 per annum (R. 153-154; Pet. Br. 8), as the Board found (R. 42).

to the operation and management of Consolidated, a separate corporation, which printed and published the taxpayer's and others' newspapers. (R. 36, 69-70, 143-144.)

Since the president devoted practically all of his time to Consolidated for which the taxpayer, not Consolidated, paid the entire salaries in dispute (R. 36-37; Pet. Br. 8-9), the question for decision is simply this—whether the taxpayer may properly claim as a deduction, as ordinary and necessary business expenses, the salaries paid its president as the fair value of the services he actually rendered directly to another corporation even though the services performed benefited Consolidated directly but the taxpayer and the several other stockholders of Consolidated only indirectly (that is, through dividend distributions) during each of the taxable years.

The taxpayer contends, substantially as it did before the Board (R. 44), that its business during the taxable years was not merely that of a passive investor but rather it constituted the active operation and management of Consolidated through its officers and employees, particularly its president; and that therefore, corporate equities aside, the amounts paid its president in connection with the carrying on of such business during those years constituted deductible ordinary and necessary business expenses (Br. 13, 18-25).

The Board held that the taxpayer is not entitled to deductions for the claimed salaries as ordinary and necessary business expenses for the reasons that it, merely a two-thirds stockholder of Consolidated,

lacked complete control and domination of the latter and had practically no control over the authorization of its officers' salaries; the \$12,000 salary paid the president was conceded by taxpayer's counsel not to be an "ordinary salary"; taxpayer and Consolidated were distinct and separate corporate entities which may not be disregarded or ignored; Consolidated was owned through stock ownership of the taxpayer and others, all of whom received income merely through dividends paid by Consolidated; the salary payments inured to the benefit of the taxpayer, as a stockholder of Consolidated, only indirectly and in proportion to the stockholdings which were equally and proportionately beneficial to the other stockholders of Consolidated; and that taxpayer rendered no such service for Consolidated as to warrant its deducting, as ordinary and necessary expenses of a trade or business, the expenditure incurred. (R. 42-45.) We submit the Board was correct in so holding.

The pertinent statute and regulations allow as deductions for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business reasonable sums for salaries or other compensation for personal services actually rendered. Section 23 (a), Revenue Acts of 1936 and 1938; Article 23 (a)-6, Treasury Regulations 94, Appendix, *infra*. In this connection, this Court has held substantially that the Board, taking into consideration all the facts and circumstances, may determine as a fact and ascertain what is a reasonable compensation commensurate with the services actually rendered to a corporation by

the person to whom the payment was made; that if the salary paid by the corporation to an officer exceeded the reasonable value of the services actually rendered to it, the corporation may deduct only such amount as found by the Board to be the reasonable value of the services rendered; and that the Board's decision is conclusive if supported by substantial evidence. *Doernbecher Mfg. Co. v. Commissioner*, 95 F. 2d 296, 297.

In the present case, the Board found, upon the evidence, that the Commissioner's determination and allowance of deductions for salaries in the amount of \$2,000 for each of the taxable years was reasonable and commensurate with the services rendered taxpayer by its president, and therefore approved the determination. (R. 42.) There is ample evidence to support the Board's finding—Wilson was president of both the taxpayer and Consolidated and the services he performed for the business of each were in some respects materially different; taxpayer did not itself print and publish the Los Angeles Daily Journal and owned no printing presses; and in the operation of its business affairs, separate and distinct from the management of Consolidated, comparatively little of the president's time and attention was demanded, required or rendered since practically all of it was devoted to Consolidated. (R. 36, 37, 69-70, 89.) Since the Board found and the evidence shows that the annual allowance (\$2,000) made by the Commissioner was commensurate with the services actually rendered to the taxpayer by its president, and the portion thereof

(\$10,000) disallowed by the Commissioner exceeded the reasonable value of the services actually rendered to it, it would seem necessarily to follow that, under the rules laid down by this Court in the *Doernbecher* case, taxpayer may deduct only the amount (\$2,000) found by the Board to have been the reasonable value of the services rendered to it.

There is nothing express or implied in the statute or regulations to indicate that such expenses may be deducted by the taxpayer in connection with the carrying on of *another's* trade or business. Under taxpayer's theory, however, its interest as a stockholder in Consolidated was so active that its president's devotion of practically all his time and efforts to the management and operation of Consolidated constituted the *taxpayer's* carrying on the business of Consolidated. (Br. 18, 22-23.) Even though there was an understanding and agreement among the parties to the consolidation in 1929 that Wilson would thereafter continue to act, without compensation from Consolidated, as president and general manager of the latter in the printing and publication of all the newspapers theretofore published separately by the several parties to the agreement (R. 33), the fact nevertheless remains that the same was true of all the other officers of Consolidated. It was agreed that none of "the executive officers of said new corporation" would charge or receive any salaries for their services rendered to Consolidated unless otherwise ordered unanimously by the directors (R. 35, 65, 67, 115), and that all of such officers would use their best efforts to further and

promote the business of Consolidated (R. 36, 118-119). There are further facts showing that taxpayer, merely one of the several contracting parties and stockholders, had substantially no more control over Consolidated than the other stockholders. Taxpayer owned only approximately two-thirds of the total outstanding stock of Consolidated and any authorization of salaries for the officers of the latter required the affirmative unanimous vote of the entire board of directors. (R. 34, 35, 43, 65, 67, 144-145.) The purpose of the agreement requiring such unanimous action was to prevent the taxpayer from controlling the policy of Consolidated in respect to salary payments. (R. 66, 67, 68.) Consolidated was owned through the respective stockholdings of the taxpayer and others to the end that each of the parties to the agreement, including the taxpayer, was alike merely an indirect beneficiary, solely through dividends paid by Consolidated in proportion to its stockholdings, of the increased profits resulting from Wilson's participation in the conduct and management of Consolidated during the taxable years herein. (R. 34, 143-145.) Not only did Wilson and the other officers, under the agreement, devote their entire time to the affairs of Consolidated in order to increase its profits for all of its stockholders (R. 33, 36), but Wilson plainly was not required to devote any of his time or efforts to the direct management of the taxpayer's affairs, in spite of which taxpayer, and not Consolidated, paid Wilson the amounts of the salaries in dispute (R. 36-37). Under these facts, it cannot be said that the taxpayer's pay-

ments to Wilson for his services actually rendered to Consolidated to produce profits for the taxpayer and the other stockholders in proportion to their stockholdings, constituted ordinary and necessary expenses paid or incurred during the taxable years in carrying on the *taxpayer's* trade or business. Yet, such is the requirement of the statute and regulations (Section 23 (a) of the Revenue Acts of 1936 and 1938; Article 23 (a)-6 of Treasury Regulations 94) in order that such expense items may be deductible from gross income. *Seufert Bros. Co. v. Lucas*, 44 F. 2d 528, 530 (C. C. A. 9th). There this Court stated (p. 530):

The statute by its terms seems to cover usual or common expenses having relation to *the taxpayer's income*, as distinguished from exceptional and extraordinary outlays. * * *
[Italics supplied.]

We submit the foregoing is true since the claimed expenditure on the part of the taxpayer alone, as distinguished from the other stockholders, was neither an ordinary, necessary nor reasonable expense made for the conduct of its own business by reason of the fact that the advantage therefrom flowed not only to the taxpayer but also equally in proportion to the other stockholders who paid no part of the disputed amounts. Consequently, the claimed deductions are not allowable. *Coosa Land Co. v. Commissioner*, 29 B. T. A. 389, affirmed in part without discussion of this point, 103 F. 2d 555 (C. C. A. 5th); *Martin v. Commissioner*, 28 F. 2d 748 (C. C. A. 8th); cf. *Welch v. Helvering*, 290 U. S. 111; *Keck Investment Co. v. Commissioner*, 29 B. T. A. 143, affirmed, 77 F. 2d 244

(C. C. A. 9th), certiorari denied, 296 U. S. 633 (where the Board, in response to the contention that if the taxpayer had not financed the Superior Oil Company, its investment therein would have been lost, stated that the business of the Superior Oil Company was not the business of the taxpayer-stockholder, and that there was no obligation upon the latter to manage the affairs or to contribute to the financial requirements of the corporation); *Menihan v. Commissioner*, 79 F. 2d 304 (C. C. A. 2d), certiorari denied, 296 U. S. 651; *Howell v. Commissioner*, 69 F. 2d 447 (C. C. A. 8th), certiorari denied, 292 U. S. 654; *Ritter Lumber Co. v. Commissioner*, 30 B. T. A. 231; *Security First Nat. Bank of Los Angeles, Executor v. Commissioner*, 28 B. T. A. 289; *du Pont v. Commissioner*, 37 B. T. A. 1198.

Coosa Land Co. v. Commissioner, *supra*, is a case in point. There the Board, as affirmed, held that the payment made by the taxpayer for the services of a watchman which it employed to guard its subsidiary corporation, of which it was the principal stockholder, was not deductible from its income as a business expense in the year paid. The Board stated (pp. 393-394):

Respecting this claim, we think it is only necessary to say that it was a business charge of the Alabama Lime & Stone Corporation [the subsidiary] and not an ordinary and necessary expense of the petitioner's business. (See sec. 23 (f) and (g), 1928 Act.) The petitioner was only a stockholder of the Alabama Lime & Stone Corporation. The duty of protecting a corporation's property belongs to it and not

to the stockholders. The expenditure thus made must be regarded either as a loan to the Alabama Lime & Stone Corporation, or as a capital investment to be added to the cost of petitioner's stock in that company. *Harry E. Lutz*, 2 B. T. A. 484; *John G. Paxton*, 7 B. T. A. 92; *Warren E. Burns*, 11 B. T. A. 524; *B. Estes Vaughn*, 17 B. T. A. 620; *Snider B. Ward*, 18 B. T. A. 326; *W. F. Bavinger*, 22 B. T. A. 1239; *Burns v. Commissioner*, 31 Fed. (2d) 399; 280 U. S. 564.

Mastin v. Commissioner, *supra*, is very nearly in point. There a stockholder paid certain sums of money for advertising real estate owned by the corporation because he considered it an advantageous movement for the corporation and its stockholders whereas the other stockholders paid nothing in this connection. Disallowing the deduction claimed by the taxpayer-stockholder as a business expense or a loss, the court said (pp. 752-753):

In the case of *Mente v. Eisner* (C. C. A.) 266 F. 161, 11 A. L. R. 496, the court, in construing a somewhat similar provision in the Revenue Act of 1913 (38 Stat. 114), used the following language in speaking of "losses":

"We think that the language 'losses incurred in trade' are correctly construed by the Treasury Department as meaning in the actual business of the taxpayer, as distinguished from isolated transactions. If it had been intended to permit all losses to be deducted, it would have been easy to say so. Some effect must be given to the words 'in trade'."

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As to the payment by petitioner for advertising certain of the real estate belonging to the corpus of the trust estate, the Board of Tax Appeals made the following finding of fact:

“The petitioner in 1919 paid out the sum of \$4,245.25 to Brent & Crittenden, real estate agents, for advertising real estate owned by the Mastin Realty & Mining Company. The petitioner owned stock in the corporation but did not own any of the real estate which was to be advertised. The other stockholders of the corporation did not pay out anything in this connection. The petitioner paid out the money because he deemed it an advantageous movement for the corporation and its stockholders. The Mastin Realty & Mining Company and others owned large property interests on the southern border of the principal business district of Kansas City. A movement was started by the parties to advertise this section. The amount so paid to Brent & Crittenden was to be distributed by them.”

The payment was therefore made, not by petitioner to advertise his own real estate, not by the corporation to advertise real estate owned by it, but by petitioner as a voluntary one. It was, in our opinion, a capital expenditure, which might enhance the value of petitioner's stock by increasing the value of the lands of the corporation. It was not a loss within the meaning of the statute under discussion. *Duffy v. Central R. Co. of N. J.*, 268 U. S. 55, 45 S. Ct. 429, 69 L. Ed. 846.

In *Welch v. Helvering, supra*, the Court held that the payments, made by a grain commission agent who

was secretary of a bankrupt corporation engaged in the grain business, to the corporation's creditors for the purpose of strengthening his individual standing and credit and reestablishing his business relations with the corporation's former customers, were not deductible from his income as ordinary and necessary business expenses. The Court stated (pp. 113-114):

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. *McCulloch v. Maryland*, 4 Wheat. 316. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. * * *

In *Menihan v. Commissioner, supra*, where the taxpayer made payments to benefit the corporation in which he was the sole stockholder, the court held that the loss sustained by the corporation could not be deducted by such sole stockholder in determining his taxable income. The court stated (pp. 305-306):

The inquiry comes down to whether or not the payments were deductible losses sustained either

in his trade or business (subdivision (a) (4) of section 214, 26 USCA § 955 (a) (4) * * *. Although the petitioner owned or controlled all of the stock of the Menihan Company, any loss which was incurred in its trade or business was that of the corporation. It was a separate and distinct entity doing business for itself and not as the petitioner's agent. Whatever losses were incurred in that business were deductible, if at all, only from the income of the corporation itself. See *Dalton v. Bowers*, 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389. There is no basis appearing in this record for disregarding the corporate structure. The fact that petitioner owned or controlled all of the corporation's stock is alone insufficient ground for that. *American Union Line v. Oriental Nav. Corp.*, 239 N. Y. 207, 146 N. E. 338. Indeed, the petitioner insists that the usual distinction between corporation and stockholder should be preserved here, and with that we are in entire agreement.

* * * * *

The cases relied upon by taxpayer (Br. 16, 18-19, 21) are distinguishable. Thus, *Foss v. Commissioner*, 75 F. 2d 326 (C. C. A. 1st), and *Marsch v. Commissioner*, 110 F. 2d 423 (C. C. A. 7th), both held substantially that a person who maintains an office where he spends a substantial part of his time and devotes his time to the active management and participation in the management of his properties and companies in which his funds and properties are invested, is carrying on a business within the meaning of the statute permitting deductions for losses and ordinary and necessary business expenses from a trade or business.

Also *Helvering v. Highland*, 124 F. 2d 556 (C. C. A. 4th), held that an estate continuing the decedent's activities was engaged in a trade or business so that the expenses of the estate were deductible. Those cases, however, are not in point. Contra, are *Kane v. Commissioner*, 100 F. 2d 382 (C. C. A. 2d), and *Miller v. Commissioner*, 102 F. 2d 476 (C. C. A. 9th), both holding substantially that the taxpayers' activities in handling their own properties and investments did not constitute a trade or business within the meaning of the statutes authorizing deductions for ordinary business expenses in computing taxable net income. The *Kane* and *Miller* cases are in accord with the rules since laid down by the Supreme Court in *Higgins v. Commissioner*, 312 U. S. 212, which in effect overruled such decisions as those relied upon by the taxpayer in the *Foss*, *Marsch* and *Highland* cases; to the same effect, see *United States v. Pyne*, 313 U. S. 127; *City Bank Co. v. Helvering*, 313 U. S. 121.

The taxpayer finally states (Br. 23-24) that the Board erroneously thought it was contending that the corporate entities herein should be disregarded but that taxpayer has never even "remotely suggested that such procedure should be followed." While we agree with the taxpayer's statement that such entities should not be ignored herein, as the Board held (R. 44-45), it would nevertheless appear that such admission negatives taxpayer's contention that *its* own business, which produced a very nominal income (Br. 9), was the active business agent through its president in the conduct of Consolidated, a separate corporation (Br.

22). Taxpayer admits that it was merely a holding company and that almost its entire income came from the dividends declared and paid on its Consolidated stock. (Br. 8-9, 10.) Since, therefore, the two corporations were admittedly separate entities (*Inland Development Co. v. Commissioner*, 120 F. 2d 986, 988 (C. C. A. 10th)), and their businesses were separate, distinct and materially different in many respects, as the Board found (R. 42) and held (R. 44), there is no basis for the contention that the salaries paid by taxpayer to its president for his services in carrying on the business activities of another corporation constitute allowable deductions as *its* ordinary and necessary expenses of business. They were clearly a proper expense incurred by Consolidated for the conduct of its business in publishing the taxpayer's and the other stockholders' newspapers and therefore deduction of such amounts from the taxpayer's income would clearly amount to the improper distortion of its taxable income. This would be contrary to the provisions of the statute that net income must be computed upon such basis of accounting "as in the opinion of the Commissioner does clearly reflect the income" (Section 41 of the Revenue Acts of 1936 and 1938). Obviously, therefore, if Consolidated, a separate legal entity, required and used the services of taxpayer's president or any other individual for the conduct of its business affairs, it alone and not the taxpayer is entitled, under the taxing statutes, to deduct the expenses thereof. *Seufert Bros. Co. v. Lucas*, *supra*, p. 530; *Menihan v. Commissioner*, *supra*, pp. 305-306.

In view of the foregoing, it seems clear that taxpayer is not entitled to deduct, as ordinary and necessary expenses for the taxable years 1936-1938, the amounts paid its president and disallowed by the Commissioner as compensation for personal services actually rendered by him directly to Consolidated, a separate corporation, during those years.

II

No part of the amounts taxpayer paid its president during the taxable years 1937-1938 constituted a distribution of dividends, and therefore taxpayer is liable for personal holding company surtaxes for those years

Taxpayer further contends that regardless of the deductibility of the salaries claimed, it accumulated no earned surplus during the years 1937-1938 since the portion of the salaries paid to Wilson and disallowed by the Commissioner constituted a distribution with the result that it is not liable for personal holding company surtaxes on any amount for those years. (Br. 26-28.)

The Board held that the taxpayer is not entitled to any dividend-paid credit in the computation of its tax liability because even though the excess disallowed salaries be considered as dividends, they were not within the purview of the statutes authorizing such credits, and consequently it is liable for the surtaxes as asserted by the Commissioner. (R. 45.)

The pertinent statutes levy surtaxes upon the undistributed adjusted net income of personal holding companies. Section 1 of the Revenue Act of 1937, amending Section 351 of the Revenue Act of 1936,

Appendix, *infra*; Section 401 of the Revenue Act of 1938, Appendix, *infra*. They provide for dividend-paid credits against income to the extent of dividends paid during the taxable year (Section 27(a), Revenue Act of 1936, Appendix, *infra*), but they also provide further as follows (Section 27(g), Revenue Act of 1936, Appendix, *infra*):

Preferential Dividends.—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

Under the specific wording of the statutes, therefore, even though the disallowed portions of the excess salaries be considered as dividends, the taxpayer is nevertheless not entitled to any dividend-paid credit in the computation of its tax liability for the years in question for the reason that the claimed dividend distribution was not “pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class” (Section 27(g)) as the Board properly held. (R. 45.)

Even though this result may be inequitable and is allegedly not within the spirit of the statute, as taxpayer states (Br. 26-27), the fact nevertheless remains that the terms of the statutes are specifically applicable and controlling herein and must therefore be given effect. The record is clear that the amounts in question were paid to taxpayer’s President Wilson as salaries and not as dividend distributions. There is no showing that any portion thereof was authorized

as a dividend by the taxpayer's directors or stockholders, or that any of the stockholders, other than Wilson, participated in the payments. Dividend-paid credits are not allowable under Section 27 in any event where the distribution is not pro rata alike to all the shareholders. *May Hosiery Mills, Inc. v. Commissioner*, 123 F. 2d 858 (C. C. A. 4th). Moreover, disallowance by the Commissioner of salaries paid by a corporation to its officers does not transmute the amount disallowed into a dividend. *Hayner v. United States*, 62 C. Cls. 189.

Pembroke Realty & S. Corp. v. Commissioner, 122 F. 2d 252 (C. C. A. 2d), relied upon by taxpayer (Br. 27-28), is not in point. There the taxpayer had net income for the taxable year of more than \$87,000, and at the end of the year dissolved and distributed all its assets to its shareholders. The court held that the distribution was a dividend as defined in Section 115 (a) of the Revenue Act of 1934—any distribution made by a corporation to its shareholders out of its earnings or profits accumulated after February 28, 1913—and that therefore the Revenue Act of 1934 did not impose the surtax upon the corporation which had distributed all its property to its stockholders. The provisions of the Revenue Act of 1934, however, were very different from those of the Revenue Acts of 1936, 1937 and 1938 involved in the instant case where dividend-paid credits are specifically not allowable under the facts herein.

Accordingly, we submit that the taxpayer is liable for the personal holding company surtaxes herein

since no part of the amounts it paid its president during the taxable years 1937-1938 constituted a distribution of dividends within the meaning of the pertinent statutes.

CONCLUSION

The decision of the Board of Tax Appeals in respect to both Points I and II, *supra*, is correct and in accord with law and the authorities. It should therefore be affirmed.

Respectfully submitted,

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JANUARY, 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses*.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General*.—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * *

(g) *Preferential Dividends*.—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

* * * *

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

* * * *

(b) *Definitions*.—As used in this title—

* * * *

(2) The term “undistributed adjusted net income” means the adjusted net income minus the sum of:

* * * *

(C) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over).

* * * *

Revenue Act of 1937, c. 815, 50 Stat. 813:

TITLE I—PERSONAL HOLDING COMPANIES

SEC. 1. AMENDMENT OF 1936 ACT.

Title IA of the Revenue Act of 1936 is amended to read as follows:

“TITLE IA—ADDITIONAL INCOME TAXES

“SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

“There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

“(1) 65 per centum of the amount thereof not in excess of \$2,000; plus

“(2) 75 per centum of the amount thereof in excess of \$2,000.

* * * *

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses*.—

(1) *In General*.—[Section 23 (a) (1) of this Revenue Act is the same as Section 23 (a) of the Revenue Act of 1936] * * *.

* * * *

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

* * * *

(b) *Basic Surtax Credit*.—As used in this title the term “basic surtax credit” means the sum of:

(1) The dividends paid during the taxable year, increased by the consent dividends credit provided in section 28, and reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations;

* * * *

(h) *Preferential Dividends*.—The amount of any distribution (although each portion thereof is received by a shareholder as a taxable dividend), not made in connection with a consent distribution (as defined in section 28 (a) (4)), shall not be considered as dividends paid for the purpose of computing the basic surtax credit, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference. For a distribution made in connection with a consent distribution, see section 28.

* * * *

SEC. 401. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year, upon the undistributed Title IA net income of every personal holding company (in addition to the taxes imposed by Title I) a surtax equal to the sum of the following:

(1) 65 per centum of the amount thereof not in excess of \$2,000; plus

(2) 75 per centum of the amount thereof in excess of \$2,000.

* * * *

SEC. 403. PERSONAL HOLDING COMPANY INCOME.

For the purposes of this title the term "personal holding company income" means the portion of the gross income which consists of:

(a) Dividends, interest (other than interest constituting rent as defined in subsection (g)), royalties (other than mineral, oil, or gas royalties), annuities.

* * * *

SEC. 405. UNDISTRIBUTED TITLE IA NET INCOME.

For the purposes of this title the term "undistributed Title IA net income" means the Title IA net income (as defined in section 406) minus—

(a) The amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraphs (3) and (4) thereof (computed without its reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations); but, in the computation of the dividends paid credit for the purposes of this title, the amount allowed under subsection (c) of this section in the computation of the tax under this title for any preceding taxable year shall be considered as a dividend paid in such preceding taxable year and not in the year of distribution;

* * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (a)-6. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While

any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

ART. 23(a)-7. *Treatment of excessive compensation.*—The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they

should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient and subjected to both normal tax and surtax.

No. 10240

IN THE

United States Circuit Court of Appeals
FOR THE NINTH CIRCUIT

DAILY JOURNAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONER.

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FILED

JAN 23 1943

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CLERK

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REPLY BRIEF FOR PETITIONER.

I.

Respondent Misstates the Issue Involved.

Respondent states that the question presented is "whether the taxpayer is entitled * * * to deduct the full amounts paid to its president, Douglas W. Wilson, as reasonable compensation for services rendered by him to another corporation during each of the taxable years 1936, 1937 and 1938." (Br. 2.)

This statement *assumes* that petitioner, in conducting the affairs of Consolidated through said Wilson, was not

carrying on a trade or business and that Wilson in managing Consolidated was *not* acting for petitioner. But these are the very issues which this Court must decide in this proceeding.

As has been repeatedly pointed out, petitioner contends that its president in managing the affairs of Consolidated *was acting for petitioner and no one else*. Petitioner further contends that after the consolidation in 1929, petitioner's trade or business was the management of the new company, and that it could only and did carry on such trade or business through its agent, Wilson. Finally, petitioner submits that the salary paid Wilson for services thus rendered petitioner was reasonable and constituted an ordinary and necessary expense of petitioner's trade or business and was hence deductible in determining petitioner's taxable net income.

These are the *real* issues in this case.

Respondent has assumed that petitioner is claiming the disputed deduction on the theory that its business is that of Consolidated, that is, accepting advertisements, printing papers, etc. Such is not the case. *Petitioner's business is the management of its principal investment. This management is active, not passive.* This management can likewise only be effected by operating Consolidated through petitioner's agent, Wilson. This method of approach, which is fundamental, has been overlooked entirely by respondent.

II.

Respondent Is Mistaken in His Understanding of the Facts Involved.

(a) Respondent states (Br. 16) that under the consolidation agreement, the “officers” of the new corporation were required to use their best efforts to further and promote the latter’s business.

The fact is that the *predecessor corporations including petitioner* were the persons who were required to “use their best efforts and endeavors to further and promote the business of said new corporation” [Tr. 118]. This is exactly what petitioner was doing in requiring its president, Wilson, to manage Consolidated.

(b) Respondent states (Br. 17) that petitioner “had substantially no more control over Consolidated than the other stockholders.” This statement is entirely incorrect as is indicated by the holdings of petitioner in Consolidated during the years in question [Tr. 34].

	Class B Preferred	Common
Total Shares Outstanding	5,000	3,500
Shares Owned by Petitioner	3,258	2,340

Likewise, on cross-examination, Wilson stated, “We control the board of directors on the Consolidated. Therefore, our decision is final on any action taken” [Tr. 85].

Petitioner lacked complete control of Consolidated only with respect to the salaries to be paid by it to its executive officers. Here the original consolidation agreement

required the unanimous consent of Consolidated's Board of Directors. This was agreed to by the parties to the consolidation including petitioner, because it was always assumed that petitioner would manage Consolidated through petitioner's president, and that for such services rendered to petitioner by its president, petitioner would compensate him.

(c) Respondent states (Br. 17), "Wilson plainly was not required to devote any of his time or efforts to the direct management of the taxpayer's (petitioner) affairs."

The evidence with regard to this point is all to the contrary. Wilson's testimony [Tr. 63-90] conclusively shows he was required and directed by petitioner's Board of Directors to manage Consolidated. In complying with these instructions, he was hence *working directly for petitioner*.

In other words, respondent in this proceeding *assumes* that petitioner's business could not possibly consist of the management of Consolidated. Upon this premise, respondent grounds his entire argument.

III.

Respondent Clearly Erred in Concluding That Petitioner Was Not Engaged in the Business of Managing Its Principal Asset, Namely Consolidated, During the Years in Question.

Respondent's argument in this particular is apparently based upon the following considerations:

(a) It is claimed that petitioner had no more control over the affairs of Consolidated than did its other stockholders. As has already been pointed out, this was clearly not true.

(b) Since a portion of the benefits accruing from the management of Consolidated through Wilson accrued to others than petitioner, it is claimed that petitioner's business could not consist of the operation of Consolidated.

Throughout his brief, respondent seems to contend that petitioner's business cannot consist of the management of Consolidated because petitioner did not own *all* of Consolidated's stock. This we submit is totally without merit. The extent of stock ownership is of little value in determining whether or not the taxpayer is engaged in business with respect to the corporation in question. A taxpayer may own 100% of a corporation's stock and still not be engaged in the business of managing said company. At most, it would seem that a taxpayer need only own a majority of the stock since such majority would be required for the control which is generally necessary for effective management. More than majority control clearly existed here.

In *Helvering v. Highland, Exec.*, 124 Fed. (2d) 556 (C. C. A. 4th, 1942) the decedent's estate owned a *majority only* of the stock of the Clarksburg Publishing Company. Said estate's executor was the president and general manager of said corporation. The Court held that the estate was engaged "actively in the newspaper business."

It seems too clear to require further elaboration that the bases upon which respondent grounds his contention that petitioner was not engaged in business so far as Consolidated was concerned are without merit.

IV.

Respondent Has Confused the Law Applicable to This Proceeding.

(a) In its opening brief, petitioner cited and relied on the cases of *Foss v. Commissioner*, 75 Fed. (2d) 323 (C. C. A. 1st, 1935), *Marsch v. Commissioner*, 110 Fed. (2d) 423 (C. C. A. 7th, 1940) and in particular on *Helvering v. Highland, supra*.

Respondent brushes these authorities aside, stating that they "are distinguishable" (Br. 23). He later says: "those cases, however, are not in point" (Br. 24). No reason for such statement appears any place in respondent's brief, nor does respondent even attempt to point out why they are distinguishable or not in point.

Respondent then refers to the cases of *Kane v. Commissioner*, 100 Fed. (2d) 382 (C. C. A. 2d, 1938) and *Miller v. Commissioner*, 102 Fed. (2d) 476 (C. C. A. 9th,

1939). With respect thereto, respondent says that both the last two named cases hold

“substantially that the taxpayers’ activities in handling their own properties and investments did not constitute a trade or business within the meaning of the statutes authorizing deductions for ordinary business expenses in computing taxable net income. The *Kane* and *Miller* cases are in accord with the rules since laid down by the Supreme Court in *Higgins v. Commissioner*, 312 U. S. 212, which in effect overruled such decisions as those relied upon by the taxpayer in the *Foss*, *Marsch* and *Highland* cases * * *.”

It is obvious that respondent’s brief was prepared in haste. The *Higgins* case was decided by the Supreme Court February 3, 1941; the Fourth Circuit Court decided the *Highland* case on January 5, 1942, almost a year later. Under no circumstances did the Fourth Circuit feel that it was failing to follow the Supreme Court’s interpretation of the law in the *Higgins* case. In fact, the Court in the *Highland* decision referred to and quoted from said *Higgins* decision.

In the *Higgins* case, a “passive investor” sought to deduct the expenses of maintaining an office from which said investments were managed. In denying the deduction, the Supreme Court said in part: “To determine whether the activities of a taxpayer are ‘carrying on a business’ requires an examination of the facts in each case. * * * The petitioner merely kept records and collected interest and dividends from his securities. * * *”

The *Kane* and *Miller* cases specifically recognized the legal principle for which petitioner is here contending,

and which was later announced by the Supreme Court in the *Higgins* case. In the *Kane* proceeding, the taxpayer sought to deduct fees paid to a trust company for collecting income and amounts paid for office rent and book-keeper's salary. In denying the claim, the Court said in part: "In the prevailing opinion of the Board, it was said that the taxpayer 'merely received income from investments and this is not a trade or business.' While we do not say that a taxpayer might not carry on a business through an agent, it was not shown here that enough was done either by the taxpayer or her agents to constitute the carrying on of a business."

In the *Miller* case, we have the same situation. There the decedent Bloom engaged in no business except the supervision of the investments of a revocable trust. He maintained an office which he visited a few hours every day. He employed two individuals to do clerical work, make up income tax returns, and read trade journals and financial services.

It is too obvious to require extended consideration that Mr. Bloom was a passive investor, and was not engaged in a trade or business. He was hence not entitled to a deduction for the salaries of his clerks, and the rent of his office.

Respondent is clearly in error, therefore, in stating that the *Higgins* case overruled the cases cited and relied upon by petitioner. It obviously could not overrule a case decided a year later.

Further, the *Kane* and *Miller* cases are not in conflict with the *Foss*, *Marsch* and *Highland* cases. The Courts in the *Kane* and *Miller* proceedings simply found that the

taxpayers were passive investors. *Upon the facts, no other conclusion could possibly have been reached.* In the *Foss, Marsch* and *Highland* cases, the Courts found that because of the facts involved, the taxpayers were carrying on a trade or business. That is exactly what petitioner contends in the instant proceeding. Again, we submit that the facts preclude any other finding.

(b) The cases cited by respondent in his brief are not in point here.

Respondent cites a number of cases in which taxpayers were denied the deductions claimed. It is unnecessary for us here to comment in detail with respect to such cases. We have examined them all, and we respectfully submit that they fall into either one or the other of the following classifications:

(1) No contention was made by the taxpayer that the expenditure was in connection with his trade or business. *Coosa Land Co. v. Commissioner*, 29 B. T. A. 389 (1933). Here the company with respect to which the taxpayer made the challenged expenditure *had suspended operations*. Not only did the taxpayer not contend that its trade or business was the management of said company, but such a contention had it been made could obviously not have been sustained.

(2) The Court found that as a matter of law, the activity of the taxpayer did not constitute the carrying on of a trade or business as that term was used in the applicable statute. The case of *Kane v. Commissioner*, *supra*, is an example.

Respondent has failed to indicate why petitioner in managing Consolidated was not carrying on a trade or business. By the same token, he has made no effort to distinguish the case of *Helvering v. Highland, supra*, the most recent of all the cases cited, which we respectfully contend is squarely in point and should carry great weight with this Court.

Conclusion.

In conclusion, the following is respectfully submitted:

(a) Petitioner was clearly engaged in the business of managing Consolidated during the years in question.

(b) There is no real dispute as to the law applicable. Petitioner respectfully asserts that this proceeding falls squarely in the rule announced in the case of *Helvering v. Highland, supra*.

It follows that the amounts paid by petitioner to its president, Wilson, are deductible as ordinary and necessary expenses in the years involved.

(c) On respondent's own statement, any other conclusion will work a harsh and inequitable result upon petitioner. (Respondent's Brief, 27.)

Respectfully submitted,

LATHAM & WATKINS,

By DANA LATHAM,

RONALD C. ROESCHLAUB,

1112 Title Guarantee Building, 411 West Fifth
Street, Los Angeles, California,

Attorneys for Petitioner.

5

102-40

DAILY JOURNAL COMPANY)

v.)

COMMISSIONER OF INTERNAL REVENUE)

No. 10240

SUPPLEMENTAL LIST OF AUTHORITIES
FOR RESPONDENT SUBMITTED AT ORAL
ARGUMENT, MARCH 22, 1943.



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DAILY JOURNAL COMPANY)

No. 10240

v.)

COMMISSIONER OF INTERNAL REVENUE)

SUPPLEMENTAL LIST OF AUTHORITIES
FOR RESPONDENT SUBMITTED AT ORAL
ARGUMENT, MARCH 22, 1943.

Insert, Respondent's
Brief.

On conclusiveness of Board's findings, whether
of primary or ultimate fact--
Wilmington Trust Co. v. Commissioner,
316 U. S. 164.

U. 15

" " J. M. Perry & Co. v. Commissioner,
120 F.(2d) 125, 126 (C.C.A. 9th).

" "

On deductibility of payments--

Burnet v. Clark, 27 U. S. 410.

p. 18

Deputy v. duPont, 309 U. S. 458, 433-434.

" " Esmond Mills v. Commissioner, decided by
the Circuit Court of Appeals for the
First Circuit January 7, 1943.

" " Interstate Transit Lines v. Commissioner,
150 F.(2d) 106 (C.C.A. 9th), certiorari
recently granted by Supreme Court.

" "

capital expenditure

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1 Insert, Respondent's
2 Brief.

3 On personal holding company surtax issue--
4 American Package Corp. v. Commissioner.
5 125 F.(2d) 415 (C.C.A. 4th).

6 " "
7 O'Sullivan Rubber Co. v. Commissioner.
8 120 F.(2d) 845 (C.C.A. 2d).

9 Insert, Respondent's
10 Brief, p. 31:

11
12 "SEC. 352. DEFINITION OF PERSONAL HOLDING COMPANY.
13 "(a) General Rule.--For the purposes of this title
14 and of Title I the term 'personal holding company' means any
15 corporation if--

16 "(1) Gross income requirement.--At least 80 per
17 centum of its gross income for the taxable year is
18 personal holding company income as defined in sec-
19 tion 353; but if the corporation is a personal
20 holding company with respect to any taxable year,
21 then, for each subsequent taxable year, the mini-
22 mum percentage shall be 70 per centum in lieu of
23 80 per centum, until a taxable year during the
24 whole of the last half of which the stock owner-
25 ship required by paragraph (2) does not exist,
26 or until the expiration of three consecutive
centum of the gross income is personal holding
company income; and

"(2) Stock ownership requirement.--At any time
during the last half of the taxable year more than
50 per centum in value of its outstanding stock is
owned, directly or indirectly, by or for not more
than five individuals.

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United States
Circuit Court of Appeals
For the Ninth Circuit.

RUFO C. ROMERO,

Appellant,

vs.

P. J. SQUIER, Warden, United States Peniten-
tiary, McNeil Island, Washington,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States
for the Western District of Washington,
Southern Division

No. 10242

United States
Circuit Court of Appeals
For the Ninth Circuit.

RUFO C. ROMERO,

Appellant,

VS.

P. J. SQUIER, Warden, United States Peniten-
tiary, McNeil Island, Washington,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States
for the Western District of Washington,
Southern Division

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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Seattle, Washington

Attorney for Respondent-Appellee.

In the District Court of the United States

Western District of Washington

No. 370

In the Matter of the Application of RUFO C.
ROMERO for a Writ of Habeas Corpus.

PETITION FOR WRIT OF HABEAS CORPUS

To the District Court of the United States for the
Western District of Washington :

Your petitioner, Rufo C. Romero, would most
respectfully represent :

I. I am a citizen of the Philippine Islands, and
owing allegiance to the United States.

II. I am unjustly and unlawfully detained and imprisoned by color of authority of the United States, in the custody of the Warden, United States Penitentiary, McNeil Island, State of Washington.

III. The cause or pretext of such detention is a certain order of commitment by a general court martial held and convened at Fort William McKinley, Philippine Islands, on November 25, 1940, ordering that your petitioner be imprisoned and detained in said jail for a period of 15 years; a copy of the record of such trial is made a part hereof.

IV. Said restraint and imprisonment are illegal and in violation of Article IV and Article VI of the Amendments to the Constitution of the United States; in violation of the act of June 4, 1920, (chapter 227, subchap. II; 41 Stat. 794); and is contrary to the weight of authority and not conformable to law, in that:

1. Your petitioner, Rufo C. Romero, was a captain (14th Engineers, Philippine Scouts). He was charged of violation of the 96th Article of War. There were four specifications of conspiracy [1*] to unlawfully communicate certain maps marked "secret" to certain persons not entitled to receive such information, and unlawfully reproduce certain maps marked "secret" (R. pp. 7, 8). The maps were withdrawn at the conclusion of the trial and not made a part of the Record. The importance and secrecy of the maps, as emphasized by the prosecution, was doubtful and questioned, for they were only old maneuver maps, obsolete, and some of them

*Page numbering appearing at foot of page of original Transcript of Record.

were of the kind usually used as wrapping paper at the Engineer Office. While your petitioner was in diligent performance of his duties as a Topographical Officer of the 14th Engineers which includes the care and handling of maps and correcting them, one Major J. K. Evans, chief of intelligence, Philippine Department, United States Army, employed one Anis Gepte (prosecution's principal witness) who solicited and induced petitioner to show him the maps in question. Major Evans himself testified that he told Anis Gepte what to ask (R. p. 285). It was at his instigation, that the maps were finally shown (R. p. 266). The petitioner's house where he was searched and arrested was situated outside of the military reservation.

Major Evans made arrangements with officers of the Philippine Constabulary who are possessed of police authority, to secure search warrants (R. p. 273). A warrant was issued by the justice of the peace of the town of Pasay, Province of Rizal, Philippine Islands (a copy of which was made a part of the Record, and attached at the fifth page from the last of vol. II), directed to any police officer to search the residence of petitioner for stolen maps belonging to the United States Army, and if such were found, to bring it forthwith before him in the Justice of the Peace Court of Pasay, Rizal. Major Evans had no warrant (R. p. 290). When all was in readiness according to his instructions, he, in company with the police officers armed with the search warrant issued by the justice of the peace, entered the residence [2] of petitioner (R. p. 273).

He searched the house, took possession of anything that might be used against petitioner, and arrested petitioner and took him into custody at Fort William McKinley. He also brought the articles he seized to Fort William McKinley. (R. p. 274).

2. Petitioner engaged a civilian counsel of his own selection who was a member of the bar of the Philippine Islands. At the early stage of the trial the court martial excluded this counsel from the court room (R. p. 202).

3. The act charged resulted through the instigation and creation of the Government officer and agent and its commission procured by them. (R. pp. 266; 285; 442, 447; 513, 524-25.)

4. The original record of the proceedings transmitted to the Judge Advocate General of the Army was not complete, as required by statute.

Wherefore, your petitioner prays that a writ of habeas corpus be issued by this Court, directed to the Warden, McNeil Island, State of Washington, and that your petitioner be ordered discharged from detention and imprisonment thereat; and for such other and further relief as to this Court may appear and seem just and proper.

Dated, March 16, 1942.

RUFO C. ROMERO

Petitioner

PEDRO P. SEMSEM

Attorney for Petitioner

1126 Chaplin St., SE.

Washington, D. C.

United States of America,
Western District of Washington—ss.

Rufo C. Romero, being duly sworn, deposes and says that he is the petitioner named in the foregoing petition subscribed by him; that he has read the same and knows the contents thereof, and the said statements made are true as he verily believes.

RUFO C. ROMERO

Petitioner [3]

Subscribed and sworn to before me this 26 day of March, 1942.

[Seal]

JOHN C. BASS

Notary Public

My Commission Expires Feb. 1, 1946. [4]

[Title of District Court and Cause.]

STATEMENT OF POINTS IN SUPPORT
OF PETITION.

I. The right of the people to be secure in their persons, houses, papers, and effects against unreasonable searches and seizures shall not be violated. (a) Evidence obtained by unconstitutional use of search warrants is not admissible, and conviction of crime so obtained must be reversed. (b) Search by police officers under direction of Federal agents, contrary to laws limiting authority of such agents is unlawful and evidence obtained should be suppressed. (c) The fact that a search prosecuted in

violation of the 4th Amendment to the Constitution is successful in revealing evidence of unlawful acts does not validate it; and invalid search is not made lawful by what it brings to light.

Article IV, Amendments to U. S. Constitution;

Garske vs. United States, 1 F. (2d) 620;

United States vs. Costanzo, 13 F. (2d) 259;

United States vs. Spallino, 21 F. (2d) 567;

Byars vs. United States, 273 U. S. 28.

II. The accused shall have the right to be represented by counsel for his defense. A court-martial has no power to refuse an attorney the right to appear before it if he is properly licensed to practice in the courts of the State. Exclusion from the court room of his counsel is a clear invasion of his constitutional right notwithstanding the other counsel who remain are capable of taking care of his interests.

Article VI, Amendments to U. S. Constitution;

Act of June 4, 1920—41 Stat. 790;

Articles of War, art. 17;

R. C. L. vol. 18, p. 1072;

Jackson vs. State, 115 SW. 262;

Powell vs. Alabama, 287 U. S. 45;

Johnson vs. Zerbst, 304 U. S. 458 (decided May 23, 1938);

Smith vs. O'Grady, 61 Sup. Ct. 572 (decided Feb. 17, 1941). [5]

III. When petitioner's constitutional right against unreasonable search and seizure was violated, and further denied the assistance of counsel of his own selection, any proceedings thereafter is a denial of due process of law as secured by the 14th Amendment to the Constitution of the United States and such proceedings are void, and the court-martial no longer has authority to proceed, and was no longer a court of competent jurisdiction.

Byars vs. United States (*supra*);

Powell vs. Alabama (*supra*);

Johnson vs. Zerbst (*supra*);

Smith vs. O'Grady (*supra*).

IV. Prosecution cannot be had where it appears that the accused was induced or led to commit the act charged by active cooperation and instigation of public officers.

United States vs. Healey, 202 F. 349;

United States vs. Adams, 59 F. 674;

Dalton vs. State, 39 SE. 468.

V. When the maps which were the gist of the evidence from which petitioner was convicted were not included in the Record transmitted to the Judge Advocate General, the statute was not complied with, and the Review Board that reviewed and approved the decision had no authority to approve the sentence of the court-martial when the Record was defective.

Act of June 4, 1920, c. 227, subchap. II; 41 Stat. 794;

Articles of War, art. 35;

3 Op. Atty. Gen. 545.

VI. The authority of a court-martial is derived from the statute, and it must proceed in conformity therewith. Being an inferior court of limited jurisdiction, its judgments may be attacked collaterally, and the validity of its proceedings can be revised upon a hearing in habeas corpus. When a court-martial has disregarded the Constitution and the statute under which it was created, everything which may be done is void—not voidable.

McClaughry vs. Deming, 186 U. S. 49;

Runkle vs. United States, 122 U. S. 543;

Dynes vs. Hoover, 61 U. S. at p. 81;

Mills vs. Martin, 19 Johns. (N.Y.) 7;

Smith vs. Shaw, 12 Johns. (N.Y.) 257.

[Endorsed]: Filed Apr. 6, 1942. [6]

[Title of District Court and Cause.]

ORDER TO SHOW CAUSE

The petition of the above-named Rufo C. Romero for a writ of habeas corpus coming before the court for consideration,

Now Therefore, it is Ordered as follows:

That P. J. Squier, Warden of the United States Penitentiary at McNeil Island, Washington, show cause in the above-entitled court at Tacoma, Washington, at eleven o'clock A. M. on Saturday, April 11, 1942, or as soon thereafter as the matter can be

heard, why the prayer of the petition should not be granted;

That the said Warden is required to bring the petitioner, Rufo C. Romero, personally before the court in connection with the hearing on this order to show cause;

That the Clerk forthwith mail or deliver to Rufo C. Romero, to P. J. Squier, Warden, to the petitioner's attorney, Pedro P. Semsem, and to the United States Attorney, each an uncertified copy of this order.

Dated April 9, 1942.

LLOYD L. BLACK

United States District Judge.

[Endorsed]: Filed Apr. 9, 1942. [7]

In the United States District Court, Western District of Washington, Southern Division

RECORD OF PROCEEDINGS:

At a regular session of the United States District Court for the Western District of Washington, held at Tacoma, in the Southern Division thereof on the 11th day of April, 1942, the Honorable Lloyd L. Black, United States District Judge, presiding, among other proceedings had were the following, truly taken and correctly copied from the Journal Record of said Court as follows:

Cause No. 370

[Title of Cause.]

RECORD OF HEARING

On this 11th day of April, 1942, this matter comes on for hearing on order to show cause, directed to the Warden of the United States Penitentiary at McNeil Island, re Petition of Rufo C. Romero for a Writ of Habeas Corpus. The Petitioner is present, in custody, and by his attorney, Pedro P. Semsem; the respondent Warden appears by Oliver Malm, Assistant United States Attorney. On motion of Mr. Semsem he is permitted to appear in this court for the particular purpose of representing the Petitioner herein in this proceeding.

The Court directs the record to show as follows: Petitioner, being personally present in court, agrees that it is satisfactory to him for his counsel to have fifteen minutes' time for argument today in his presence and for the matter to be then continued in Seattle on April 16, 1942 at the hour of 1:00 P. M., for continuation of argument by counsel for the Petitioner and counsel for the Government without [8] the necessity of Petitioner's being present, he stating that it is agreeable to him that he remain in the penitentiary on April 16, 1942; that he also approves an arrangement whereby each side may submit written argument to the Court after the oral argument. Petitioner further states that this matter may be continued from time to time in his absence. Argument is had on Order to Show Cause. Peti-

tioner's Exhibit No. 1, being in two volumes, is marked for identification, and the matter is now passed to April 16, 1942 at 1:00 o'clock P.M., in Seattle.

A true copy.

Attest:

JUDSON W. SHORETT,
Clerk

[Seal] By E. REDMAYNE
Deputy [9]

[Title of District Court and Cause.]

DEMURRER

Comes now the respondent, through his attorneys J. Charles Dennis, United States Attorney, and Gerald Shucklin, Assistant United States Attorney, and demurs to petition of the applicant for writ of habeas corpus, on the ground as follows:

That the application does not state facts sufficient to constitute a cause for relief.

J. CHARLES DENNIS
United States Attorney
GERALD SHUCKLIN
Assistant United States
Attorney

[Endorsed]: Filed Apr. 16, 1942. [10]

In the United States District Court, Western District of Washington, Southern Division.

RECORD OF PROCEEDINGS:

At a regular session of the United States District Court for the Western District of Washington, held at Seattle, in the Northern Division thereof, on the 16th day of April, 1942, the Honorable Lloyd L. Black, United States District Judge, presiding, among other proceedings had were the following, truly taken and correctly copied from the Journal Record of said Court, as follows:

Cause No. 370

[Title of Cause.]

RECORD OF FURTHER HEARING

On this 16th day of April, 1942, this matter comes for further hearing, the Petitioner appearing by his attorney, Pedro P. Semsem, and the respondent Warden appearing by Assistant United States Attorney Gerald Shucklin, and further hearing being had the matter is now continued to April 20, 1942, at 11:00 o'clock A.M., at Seattle, for further hearing, at which time, it is directed by the Court, the Petitioner be present.

A True Copy.

Attest:

JUDSON W. SHORETT,

Clerk

[Seal) By E. REDMAYNE

Deputy [11]

[Title of District Court and Cause.]

RESPONDENT'S NOTES ON THE RECORD.

Captain Rufo C. Romero, Philippine Scouts, 14th Engineers, was charged in the Philippine Islands with violation of the 96th Article of War before a general court martial convened at Fort William McKinley. Four specifications were charged comprising generally that the accused had access to secret maps pertaining to the national defense which he communicated to persons not entitled to receive such information; that he unlawfully reproduced certain official maps marked secret without obtaining permission from the commanding general; that he entered into a conspiracy to communicate the maps; and that he unlawfully reproduced certain official maps of military installations without first obtaining permission from the commanding general.

Approximately the first 198 pages of the record are devoted to advising the accused of the charge against him, inquiry into his mental condition, advising him as to his rights and entering his plea of not guilty to the charges.

It was stated by the Assistant Judge Advocate that the accused was present in court (R. 4) represented by defense counsel and assistant defense counsel. The accused was then asked if he desired to introduce individual counsel to which he answered in the affirmative. He was then asked if he desired to have regular defense counsel and assistant defense counsel sit as associates and collaborate with the

[12] civilian counsel, to which the accused answered no. He wanted the regular detailed officer to conduct the defense and the civilian defense to cooperate and act as associate counsel. He gave the name of his associate counsel as Benjamin C. DeGuzman.

The specifications against the accused are outlined on R. 7 and 8. The mental condition of the accused is inquired into beginning on R. 15. Associate counsel is mentioned R. 19, R. 36. The accused himself asked questions, (R. 81). Associate counsel's absence was noted (R. 119). The prosecution cited (R. 193) Title 50, U.S.C., Section 45, with the order of the President thereunder, Title 18, U.S.C. Section 88 and Title 50, U.S.C., Section 30. Paragraph 43(b), Philippine Department Regulations, refer as to who may reproduce secret maps. (R. 195, 196).

Provisions of army regulations 380-5, paragraph 4(c) and paragraph 8(g) were read as to dissemination of secret matter. Because of this provision all non-military people and civilian personnel withdrew, including associate counsel (R. 202). No objection was made by the defense. Associate counsel Benjamin C. DeGuzman returned to the courtroom. (R. 207). During all times between R. 202 and R. 207 defendant was present with defense counsel and assistant defense counsel. Associate counsel (R. 218) made an objection to evidence. The accused through defense counsel stated (R. 224) that there was a certain amount of antipathy against the assistant defense counsel by the accused and feels there is a certain amount of antipathy on the part of the de-

fense counsel. The assistant defense counsel Ivy was [13] excused. The president of the court-martial (R. 247) stated as follows: "The court takes notice of the fact that the associate defense counsel Benjamin C. DeGuzman has withdrawn from the case." No objection was made by the accused or his defense counsel. At all times during the proceedings the accused was represented by counsel. DeGuzman later appeared in the proceedings as hereinafter noted on behalf of two defense witnesses.

The first witness at the court-martial (Gepte, R. 214) testified he entered into business transaction with one Agbay and one Cabrera whereby he would purchase certain maps on behalf of a sultan of Lingayan Gulf. See Exhibit "A" attached. At first Agbay told him about the Japanese and that they could make some money. Gepte, a civilian employee of the Philippine Army, reported this to Major Evans of Military Intelligence. He was directed by Evans to inquire whether or not he could get a map of Corregidor. Gepte met Agbay and Cabrera, returned the map of Lingayan Gulf which he borrowed as a sample to show the sultan. He was informed by the men that the sultan was asking for too little. They could give him a map of the whole Philippines. They gave the witness a list of four maps and said the price would be 65,000 pesos (a peso is worth 50c). The witness said he would talk it over with the sultan. He told Agbay he had made the price 95,000 pesos. Agbay said for the witness to tell Cabrera that the sultan had made the price 45,000 pesos and

that he and the witness would split the 50,000 pesos.

These two men told witness that since this was the [14] finish of the business they wanted him to meet Captain Romero. Witness said he was willing to see Captain Romero anywhere but was afraid of him, being an officer. On October 15 Agbay took witness out to meet Captain Romero in front of the London Restaurant. They got in Captain Romero's car. Cabrero was also there. (R. 225). They all went to Captain Romero's house where they talked the matter over and Romero then told witness that they were going to Fort McKinley in order to make the maps. They had supper at Romero's house and went to Fort McKinley. (R. 226). Captain Romero, Cabrera and witness went into the building at Fort McKinley after Romero unlocked the door. Captain Romero instructed witness to hold flashlight while he opened the safe, using the combination. Romero pulled out several papers and told witness they were private documents showing him the mark on each paper "secret" (R. 228). He put the papers back in the safe. Then Romero unlocked a chest on the floor and got out a bundle of maps and they went to the darkroom. Cabrera put on the light. Romero explained to Cabrera and witness about defenses and plans. He remembers that one was of Corregidor. He also mentioned Maribeles and Bataan and others (R. 229). Romero told witness that since it would take two or three hours to do the mapping, it would be advisable for him

to make the maps at his house the next day. He said he would photograph them. Romero put the maps in the chest and locked the safe. Romero took a roll of paper and two bottles containing liquid with him. This was for the purpose of making photographs of the map of Fort McKinley (R. 230). [15] They went back to Romero's house, (R.230) and talked about the transaction. He said he was *he was* asking 65,000 pesos for the maps and suggested that the sultan raise his price and that if the sultan agreed that witness was to call Romero the next morning and say "Ramon, you can proceed to Pampanga". This the witness did the next morning and Romero told him to call him at 9:00 A.M. Romero told witness he was going to get the maps at 1:00 o'clock and that he would photograph them at his house (R. 233). Later that afternoon he met Romero at the latter's house, at which time Cabrera was present in the darkroom. They were there about an hour. Arrangements were made to come back at 4:30 at which time the sultan was to be present and delivery made of the negatives and that a corresponding amount of 50,000 pesos was to be paid. The witness then proceeded to Major Evans, Military Intelligence of the United States. The plans concerned the national defense (R. 256).

Captain Johnson (R. 267) testified to seeing Romero leave Fort McKinley with a bundle of papers under his arm. Major Evans (R. 270) testified that some 43 forgery maps and documents were found

in Romero's house; that Cabrera was present with the accused. Romero told Evans that heavy debts occurred from gambling losses was what impelled him to do what he did (R. 276). Major Evans did not make the raid. (R. 270). Captain Gabriel of the Philippine Constabulary testified he had a search warrant (R. 372) to enter Captain Romero's residence (R. 293, 295). Witness (R. 295) told Captain and Mrs. Romero that he had a search warrant and that it was necessary to inform them and to [16] read the contents to them. Both of them told witness there was no necessity to read the warrant and they allowed witness to conduct search of the house. The search warrant was returnable before the Justice of the Peace Court in Pasay (R. 297). On R. 297 a stipulation was entered into between the prosecution and defense that the search warrant authorizing search of the premises and the person of the accused at 100 Del Pan, Pasay, Rizal, Philippine Islands, on October 16, 1940, was issued and executed under competent authority of the laws of the Philippine Commonwealth (a copy of the search warrant is a part of the record in Volume 2, fifth from the last page).

Louis Alfonso (R. 306) member of the Philippine Constabulary, Pedro E. Flores (R. 310) member of the Philippine Constabulary, and Avelino Villafria, First Lieutenant of the Philippine Constabulary (R. 312) participated in the investigation.

Lt. Colonel Harland F. Seeley (R. 323) testified

that the maps (R. 333) were property of the United States and pertained to the National Defense. Other witnesses were Colonel H. A. Stickney (R. 340) and Lieutenant Page (R. 346).

Captain Gabriel testified that Gepte had operated with the Constabulary and with the Chief of the G-2 of the Philippine Army (R. 374).

Romero (R. 288) was for sometime suspected as a Japanese agent.

Ignatio Agbay (R. 403) and Gepte and Agbay (R. 427). Benjamin DeGuzman, who was acting as counsel for the witness acceded to the right of the witness (R. 408). His names appears on R. 431. He is referred to on R. 445, 448, 451, 455, 457, 460, 461, 463, 467. On R. 472 witness Agbay says [17] he will go on without his lawyer.

Cabrera testified for the defense. (R. 497). DeGuzman appeared as his attorney. He is mentioned on R. 516, 522. Romero took the stand on his own behalf (R. 551) and his rights were explained to him by the court.

The decision of the court-martial was delivered (R. 637) as follows: "To be dismissed the service, to forfeit all pay and allowances due or to become due, and to be confined at hard labor, at such place as the reviewing authority may direct, for fifteen (15) years."

The sentence was confirmed by Franklin D. Roosevelt on July 5, 1941. Chief of Staff General

G. C. Marshall ordered confinement of the accused in the United States Penitentiary at McNeil Island, Washington.

Respectfully submitted,

J. CHARLES DENNIS

United States Attorney

GERALD SHUCKLIN

Assistant United States

Attorney [18]

EXHIBIT "A"

R. 215, 216—Testimony of Gepte.

"About ten days before October 15th, I met Mr. Ignacio Agbay, whom I know about two or three months ago, in the London Restaurant, Avenida Rizal, Manila. During our conversation, we mentioned a certain Lieutenant in the Philippine Constabulary. I told Mr. Agbay that I met the said Lieutenant in the races and saw him betting heavily. Mr. Agbay told me that since this man is but a mere Lieutenant, he is surprised to see him betting so heavily. I told Mr. Agbay that I don't suppose he is making anything criminal for having all this money, as I cannot tell whether he has any connection with another nation who might furnish him money. At this instance, Mr. Agbay told me about the Japanese. Then he told me if I would like to make money he said he has a plan that he would like to introduce to me, and

I told him that it sounds all right, so I invited him to a reserved room in the London Restaurant. When we were inside the room in the London Restaurant, he told me that there was a map which indicates the defense plan and maybe we could sell them at a good price. I told him that I have lots of friends who might buy them, but that I am not very sure. However, I will look for prospects. After awhile we change the topic of our conversation and we separated. Three days later, I went to the office of Mr. Agbay in the Assessment Department, City Hall, Manila. I told him that I have a prospect and it was a Sultan from Mindanao. I asked him for the map. He told me I must come to him at his house and he is going to intruduce me to the man who has the map."

[Endorsed]: Filed Apr. 16, 1942. [19]

[Title of District Court and Cause.]

ANSWER TO RESPONDENT'S MEMORANDA

The main argument embodied in pages 1 to 3 inclusive, and up to line 21 on page 4, seems to carry the contention that a writ of habeas corpus cannot be used in place of a writ of error. Petitioner does not challenge such contention but the principles therein stated must be construed and applied so as to preserve, not destroy, constitu-

tional safeguards of human life and liberty. The scope of inquiry in habeas corpus proceedings has been broadened, not narrowed, since the adoption of the 6th Amendment. Congress has expanded the rights of a petitioner for habeas corpus—28 U.S.C. ch. 14, sec. 451, *Johnson vs. Zerbst*, 304 U. S. 458.

Respondent, on line 25, page 4, contends that petitioner was never lacking counsel and that he was represented throughout the trial. As to that, petitioner says that it was not that type of representation as would fulfill the requirement of the 6th Amendment. When petitioner's associate counsel Benjamin DeGugman, a member of the Philippine bar, was excluded from the court room when the maps were about to be introduced and where his services were vitally needed, a circumstance was thereby created which precluded the giving of effective aid in the trial of the case; a circumstance, in the opinion of the United States Supreme Court in *Powell vs. Alabama*, 287 U. S. 45, as not in compliance of due process of law. When the relation of client and attorney exists the accused has the guaranteed [20] right of having counsel represent him at any, all and every stage of his case before the Court. The fact that petitioner was represented by an Army Officer who acted as counsel, does not abridge his right to have counsel of his own selection, and as many as he sees proper to employ to defend him. It could not be reasonably implied that the exclusion was waived since the order was given by the court

composed of Army officers, who believed in orders being carried out without question or hesitation in which objection would be of no avail. If the exclusion was supposedly to be in pursuance of certain Army regulation, your petitioner contends that such regulation would not be supreme enough as to override the Constitution of the United States. In *Jackson vs. State*, 115 S. W. 262, it was therein stated that exclusion from the court room of any of his counsel is clear invasion of his right notwithstanding the other counsel who remain are capable of taking care of his interests. For these reasons, petitioner contends that the case of *Johnson v. Zerbst* would apply in this case.

In *Powell vs. Alabama*, 287, U. S. 85, the defendants were represented by counsels appointed by the court in the preliminary hearing. No counsel prepared the case of the defense. And when the trial started, the court appointed all the members of the bar in that city, and about two lawyers agreed to participate for the defense. The Supreme Court ruled that the defendants were not given effective aid so as to make it a fair trial, and they were not represented by counsel within the meaning of the 6th Amendment.

Petitioner does not agree with the contention of the respondent that "if competent and material evidence was obtained by means of a valid search warrant, it matters not out of what court such warrant was issued". To this, petitioner disagrees, and contends that a police warrant is- [21] sued

by a justice of the peace may not be used as the basis of a Federal search and seizure. And it is not material that the search was successful in revealing evidence of a Federal Statute (Byars vs. United States, 273, U. S. 28).

Petitioner does not go into the merit of the case. His contentions are that his constitutional rights have been violated and the court martial had lost its jurisdiction as a result of such violation. The right of the court martial to proceed further is challenged. Petitioner also states that the court martial did not comply with the *staute* under which it was created. He does not here, bring out the manner of how should the court martial rule on the proceedings nor does he question the merits of the case. The case of Sanford vs. Robbins cited by Respondent does not apply in the present petition.

Respondent, in his notes on the Record seem to convey the guilt of the petitioner. While it is true that petitioner associated himself with the three persons named in the record when solicited about the maps, it is equally true that among petitioner's duties was the detection and apprehension of subversive activities. Many times before the present matter, he had arrested some individuals engaged in espionage activities. His sole purpose in associating with the persons named in the Record was his desire to arrest the supposed principal in the alleged transaction. He had arrested many Japanese suspects and turned them over to his

superiors, but no steps were taken to convict them. So when he was approached and told that a Filipino, a Moro, was willing to buy some maps, petitioner had made up his mind to apprehend the principal, thinking that Army authorities would then do something about the situation. Even then, maps [22] that were of no military importance were used to detect the supposed principal.

PEDRO P. SEMSEM

Attorney for Petitioner.

[Endorsed]: Filed Apr. 20, 1942. [23]

[Title of District Court and Cause.]

ANSWER

Comes now P. J. Squier, Warden of the United States Penitentiary, McNeil Island, Washington, by and through his attorneys J. Charles Dennis, United States Attorney for the Western District of Washington, and Gerald Shucklin, Assistant United States Attorney for said District, and makes answer to the petition of Rufo C. Romero for Writ of Habeas Corpus as follows:

I.

Denies Paragraphs II and IV of the petition.

Wherefore, having answered the petition, respondent prays that Writ of Habeas Corpus be denied.

J. CHARLES DENNIS

United States Attorney

GERALD SHUCKLIN

Assistant United States

Attorney

Copy received, Pedro P. Semsem.

[Endorsed]: Filed Apr. 20, 1942. [24]

In the United States District Court, Western District of Washington, Southern Division.

RECORD OF PROCEEDINGS:

At a regular session of the United States District Court for the Western District of Washington, held at Seattle, in the Northern Division thereof, on the 20th day of April, 1942, the Honorable Lloyd L. Black, United States District Judge, presiding, among other proceedings had were the following, truly taken and correctly copied from the Journal Record of said Court, as follows:

Cause No. 370

[Title of Cause.]

RECORD OF FURTHER PROCEEDINGS

This matter comes on for further hearing on Order to Show Cause re Petition for Writ of Habeas Corpus and Demurrer of the Government

to said Petition, the Petitioner being present, in custody, and by his attorney, Pedro P. Semsem, and the respondent Warden appearing by Assistant United States Attorney Gerald Shucklin.

Government's Demurrer to the Petition is overruled and exception allowed.

On oral motion of Assistant United States Attorney Shucklin Victor D. Lawrence and Major Carroll are granted permission to be associate counsel on behalf of the Government.

On oral motion of Mr. Semsem, counsel for Petitioner, the transcript of the proceedings had at the Court Martial hearing is admitted as evidence in this case. [25]

Argument is presented and at 12 o'clock noon the hearing is continued to 1:00 o'clock P.M.

At 1:00 o'clock P.M. argument is resumed, in the presence of the Petitioner. At 1:30 P.M. argument is continued to 3:30 P.M. Respondent's Exhibit No. 1 (copy of Court Martial record of conviction and sentence), is admitted.

At 3:30 P.M. the matter comes on for further argument. Mr. Shucklin presents the original record of the Court Martial proceedings; the same is now admitted in evidence. Counsel for Petitioner now withdraws the two volumes of Petitioner's Exhibit No. 1, it being a duplicate copy of the record of the Court Martial hearing, and Petitioner's counsel advises the Court that when this matter is concluded, including the determination of any appeal taken by either side, there will be no ob-

jection on the part of the Petitioner or his counsel to the return of the transcript of the Court Martial hearing to the Judge Advocate General.

Further hearing is continued to April 27, 1942 at 3:00 o'clock P.M., at Tacoma, at which time the Petitioner and counsel are directed to be present.

A True Copy.

Attest:

JUDSON W. SHORETT,
Clerk

[Seal] By E. REDMAYNE
Deputy [26]

In the United States District Court,
For the Western District of Washington,
Southern Division

RECORD OF PROCEEDINGS:

At a regular session of the United States District Court for the Western District of Washington, held at Tacoma, in the Southern Division thereof, on the 27th day of April, 1942, the Honorable Lloyd L. Black, United States District Judge, presiding, among other proceedings had were the following, truly taken and correctly copied from the Journal Record of said Court, to-wit:

Cause No. 370

[Title of Cause.]

RECORD OF FURTHER HEARING

On this 27th day of April, 1942, this matter comes on for further hearing on Order to Show Cause re Petition for Writ of Habeas Corpus, the Petitioner being present in person, in custody, and by his attorney, Pedro P. Semsem, and the Government appearing by Assistant United States Attorney Gerald Shucklin. Further hearing is had. The Petition for Writ of Habeas Corpus is by the Court denied and the cause dismissed, to which ruling an exception is allowed. Written Findings of Fact, Conclusions of Law and Order are to be presented.

A True Copy.

Attest:

JUDSON W. SHORETT,

Clerk

[Seal] By E. REDMAYNE,
Deputy [27]

[Title of Cause.]

ADDITIONAL POINT THAT PETITIONER
WAS DENIED COUNSEL

Petitioner further states that he was denied the right to be represented by counsel in the preliminary hearings or investigation of the charges as shown in the following excerpt from his statement:

“Shortly before the investigation of the charges against me, I was permitted to see a lawyer—a certain Mr. Lynch—An American. At the investigation Mr. Lynch was not allowed to be present, and in answer to a letter of his, respectfully inquiring why he was denied attendance in spite of my request, he was told that it was not necessary that he be present. Mr. Lynch thereupon resigned as my counsel, remarking that the attitude of the military authorities was such that there was nothing he could do for me. My investigation was thus conducted without the benefit of counsel.”

Examination of the proceedings in the investigation charges as shown in the first few pages of the Record, shows that no counsel appeared for petitioner.

Respectfully submitted,

PEDRO P. SEMSEM,

Attorney for Petitioner.

[Endorsed]: Filed Apr. 24, 1942. [28]

United States District Court
Western District of Washington
Southern Division

No. 370 (Tacoma)

In the Matter of the Petition of Rufo C. Romero
for a Writ of Habeas Corpus.

ORAL OPINION

Judge Lloyd L. Black, April 27, 1942.

The case of Rufo C. Romero is a very interesting one. It is interesting in its legal aspects. It is interesting in its human aspects.

The petitioner, Rufo C. Romero, was born in the Philippine Islands, was sent to and graduated from West Point Military Academy. He was an officer in the Army in the Philippines. He became entrusted with certain maps or access to certain maps by virtue of his service in the Army, his education and, I take it, his ability. My recollection of the record is that only a few days before his arrest he received his commission as Captain, having previously been First Lieutenant. The drama of the situation as established by later events after his arrest and court martial lies in the fact that some of the maps which he is charged with having conspired to divulge to unauthorized persons concern Corregidor, Bataan, Lingayen Gulf—names that for a while have been very important names, indeed, in the fast moving history of the world.

Rufo C. Romero is appearing today for the third time before this court. I am sure that he has made a good impression upon all those who have seen him. He has been courteous, dignified, when he spoke he was brief, and he [30] gave much indication on each occasion of being a man of superior abilities.

Shortly after his promotion to the Captaincy he was arrested, tried before a court martial, convicted, and he is now serving a sentence of fifteen years in the United States Penitentiary at McNeil Island. His attorney, Mr. Semsem, has come here from Washington, D. C. His presentation of the petition, the arguments he has made, both written and oral, indicate that he has made a very careful study of the record, of the Articles of War, and of the decisions he deemed applicable.

My understanding of the petition is that it is based on four grounds. Mr. Semsem's argument has supported such understanding. He has contended that the petitioner as a defendant before the court martial did not have a Constitutional trial and that therefore the court martial lost jurisdiction of him and of the offense charged for four reasons:

First—that maps obtained by a search warrant issued out of a civil court were introduced in evidence in the court martial although a Major Evans accompanied the civil authorities during the search.

Second—that the civilian attorney that petitioner

secured to represent him before the court martial was ejected from the court room during the course of the proceeding.

Third—that he was entrapped or induced by the government witness to violate the law and then arrested for doing what he was solicited to do.

Fourth—that the record is insufficient to sustain his conviction because it does not contain all of the maps.

Those are the four vital grounds, as I understand it, supporting the petition of Rufo C. Romero.

[31]

The record in the case has been introduced in evidence. The official record from the Judge Advocate General's Department was only received just before the close of the last day of hearing before me. It was then introduced in evidence. It contains considerably more than six hundred pages. Exhibits 2 to 18, inclusive, as I remember it, are now absent from the record. In addition to the four objections that I have mentioned, it is my understanding that Mr. Semsem now suggests that the record shows that during the investigation held prior to the court martial that the petitioner had no attorney.

As I indicated in a previous oral decision this afternoon involving a petition for a writ of habeas corpus the question before a judge in this type of a proceeding is not whether or no the petitioner was guilty of the charge of which he was convicted but whether or not the court had a right to say

“yes” or “no” to the question of the defendant’s guilt.

Even though I might believe Rufo C. Romero to have been absolutely guilty beyond a shadow of any doubt if I should be convinced that the Military court lost jurisdiction of his trial I would be obligated to release him. On the other hand, if I personally should be of the opinion that if I had been a member of the court martial that I would have voted to acquit still I would have no right to release him if I believed that he was given the kind of a trial which the Constitution and the law entitled him to have. In other words, a judge here in the State of Washington today cannot substitute his judgment as to the guilt or innocence of the petitioner in place of the judgment of the several members constituting a court martial at Fort McKinley in November, 1940. [32]

I have looked through this long record so far as it seemed to bear upon any of the questions raised and have had the advantage of frequent argument by counsel. I have refreshed my memory of the Articles of War and the principles of court martial.

First, as far as the search warrant is concerned, I may say counsel for the defendant and counsel for the prosecution stipulated before the court martial as to the legality of the search warrant and its execution. The then defendant, the now petitioner, was questioned by a member of the court as to whether or not he understood what that meant. He said he did.

As to the attorney being absent from the proceedings, the question before me is whether or not the record supports such contention. Under the Articles of War a defendant tried by a court martial is entitled to have either counsel from the Army or civilian counsel. He is entitled to have his civilian attorney act as chief counsel and to have such Military defense counsel as may be designated by the court act as associate counsel. In this particular instance the petitioner at the time of the trial was given permission to have civilian counsel. He was asked if he wished the Military defense counsel to act as associate counsel to his civilian counsel. He said he did not. He stated that he wished the Military counsel named by the government as provided by the Articles of War to conduct his defense and that he desired his civilian counsel to be merely associate counsel. It is pointed out by the Staff Adjutant, who reviewed the record, that there is some question whether or not Rufo C. Romero was entitled to have a Military counsel as a chief counsel and also to have civilian counsel as associate counsel. But anyway he was given both. The result is that he was given at least as much [33] counsel as he was entitled to and perhaps more than he could technically insist upon. Unquestionably, his civilian counsel was not intended by him to be active counsel. There was a very good reason for that. Very few lawyers in civilian life in their entire experience, regardless of how much active civil practice they

may have, ever learn anything about a court martial at all. Officers in the Army are usually far more skilled as to that than is the most experienced civilian counsel. The petitioner seemed to recognize this added experience of the Military counsel. His Military counsel was never excluded from the trial. There was a time when it was stated that there was to be certain evidence as to certain secret matter or that certain secret exhibits were to be offered. At that time the civilian members of the audience were excused and the civilian counsel—the associate counsel of then Captain Romero—was likewise excused. He made no objection. This petitioner made no objection. His Military counsel made no objection. In a relatively short period the civilian counsel returned. Thereafter, in a little while the civilian counsel withdrew from the case. The petitioner made no objection. His remaining counsel made no objection. The plain inference is that the petitioner found that the civilian counsel was of no help to him. That withdrawal was either with his consent or an expression of his desire. That the members of the court martial were willing for him to attend appears from the fact that this identical civilian attorney later returned to the trial to represent and advise witnesses who were trying to free the then defendant.

On the question of entrapment, I may say that there was a conflict of testimony. There was testimony that the defendant had been guilty of

violation with respect to Military [34] maps before the government secret service man appeared upon the scene. There was evidence that the defendant's witnesses and the defendant were conspiring. There was also evidence supporting the defendant's claim of entrapment. The court martial heard the evidence on both sides of this question. It watched and heard the witnesses testify. It had before it contradictory evidence under oath by one of the defendant's witnesses. In other words, one of the defendant's witnesses on the matter of entrapment swore one way one time and swore another way another time. The members of the court martial watching his expression when he attempted to explain why he told different stories on different days evidently were not convinced by what he said.

While not mentioned in the petition, it is suggested by Mr. Semsem, and asserted by the petitioner, that the petitioner had no attorney during the investigation which preceded the trial. During this investigation the defendant was given the names of the prosecution's expected witnesses. They were examined in his presence. He was allowed to cross examine them. Some written evidence was shown to him. In practically every instance he saw fit not to cross examine any witnesses at all. The only time he did so the cross examination was extremely brief. In other words, the investigation was a preview for his benefit. He was not hurt at all. No rights were denied him. He was given more of a privilege by that preview than he could

have expected had he been tried in any criminal court of which I know. Moreover, there is nothing in the Constitution, in the Articles of War, or in any law which requires that when you give a man advance notice of what the expected witnesses will testify against him that he must be accompanied by an attorney. But assuming he should [35] have had an attorney during the investigation, nevertheless he went through the entire court martial trial, so far as I can discover, without ever suggesting that he had desired any attorney at this investigation or that he felt that he was injured in the slightest by not having had an attorney there. The first it seems that he ever complained to anyone that he wished an attorney in 1940 was when he came into this court and told us here in 1942 that he desired an attorney back in 1940 before the trial started.

During the court martial Captain Romero did not take the stand. He could have been sworn as a witness. In such event he would have been subject to cross examination. He did not take the stand, did he, Mr. Semsem, as a witness?

Mr. Semsem: No, your Honor.

Judge Black: He made a statement, which is a privilege accorded in a Military court which is somewhat different than in ordinary civilian criminal procedure. The statement was in writing. That means that he had the privilege of studying what he would say. He was not under oath. He could not be cross examined. He did not have to run the hazard of embarrassing questions. He also came

into this court. He likewise read a written statement here. He did not take the stand. He did not subject himself here to cross examination, either.

As far as his not having had an attorney in 1940 at the investigation, the statement is made by him now in 1942 at a time when the government could not possibly have opportunity to prove the contrary, regardless of how true the contrary may have been. But certainly in 1942 he speaks too late as to not having had an attorney at an investigation in 1940. [36]

As to the search warrant I may say also that I am satisfied that the stipulation that was made and the lack of objection as to the search warrant at the time the evidence was introduced determine that question against him.

I am also satisfied that his failure to object when civilian counsel was excluded temporarily from the court martial during the production of matters that were asserted to be secret settles the question against him on that score.

The decisions are clear that a court such as this, long after the trial complained of, is not going to enter into the question of whether the court martial should have believed the defendant's witnesses to the effect that he was entrapped instead of believing the prosecution witnesses to the effect that he was a man in the midst of guilty conduct who was properly investigated. That was the function of the court martial.

The fourth question still remains before the court.

When I took the record to my chambers I felt it was a very substantial question. That was the question of whether or not the conviction could stand with the maps removed from the record. I have told counsel that there would always be a question of public policy as to whether the Military was required to publish its secrets to the world if it were to try by court martial one charged with secretly giving away such Military secrets. But the record of what actually happened at the court martial settles that question.

This court martial record is interesting for another reason than I have already mentioned. It is interesting because of the prominence of some of the signatures. The certificate is by Major General Myron C. Cramer, the Judge Advocate General. The signature in approval of General [37] Wainwright, of present Philippine fame, is found. The signature of the President of the United States confirming the sentence is in this record before me. The members of the court martial, General Wainwright, the reviewing board, the Judge Advocate General, and the President of the United States believe that the proceedings of the court martial were sufficiently adequate to sustain the decision. The record was reviewed by the Staff Judge Advocate, whose written view discloses that he made a very careful and intensive analysis of the testimony of the various witnesses and of the legal points involved.

The index states where the exhibits were introduced. It shows that on page 206 certain exhibits were introduced, and I will read what was there said. After mention of certain maps, Defense Counsel says this:

“If it please the court, the Defense would like to ask the Court if these maps are to be introduced as evidence.

“Trial Judge Advocate:” (He might be likened to the United States Attorney in this Court.) “The Judge Advocate does intend to introduce these maps as evidence.”

And this is his question:

“Was anyone authorized by you to communicate these maps or any other secret maps to Mariano Cabrera and Anis Y. Gepte?

“A. No, Sir.”

Then the words of the Trial Judge Advocate:

“Subject to objection by the Defense, the Prosecution desires to introduce in evidence the blueprint map marked ‘Exhibit No. One’ and maps marked: ‘Exhibits Numbers 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, and 18.’ Exhibits 3 to 18, inclusive, are later to be withdrawn from the record due to their secret contents. Additional copies of the blueprint which is marked ‘Exhibit No. One’ are available for the examination of the Court.

“Law Member: Does the Defense Counsel desire to examine any of these maps? [38]

“Defense Counsel: The Defense Counsel has

examined these maps and has no objection to their introduction.”

Now that statement by his own counsel was made in the presence of the then defendant just a few moments after the Judge Advocate General had said this:

“Exhibits 3 to 18, inclusive, are later to be withdrawn from the record due to their secret contents.”

Exhibit 2, according to the index, is introduced on page 313. I therefore turn to page 313.

“Q. I hand you this item, marked Exhibit 2. (Handing Exhibit 2 to witness) What is it?

“A. (Examining Exhibit 2) This is one of the maps I found in the house of Mariano Cabrera, a restricted map of Lingayen.

“Prosecution: The prosecution offers in evidence, subject to objection by the defense, Exhibit #2, to be withdrawn at the end of the trial.

“President: There being no objection, Exhibit #2 will be accepted in evidence.”

This offer of Exhibit No. 2 with the provision that it should be withdrawn at the end of the trial appears in the record about one hundred pages later than the place in the record which shows the admission of Exhibits 3 to 18 after being offered in evidence with the provision that they were later to be withdrawn because secret and after defense counsel had stated they had examined those maps (Exhibits

3 to 18) and had no objection to their admission.

What actually occurred at the trial of this petitioner in 1940 is far more important than what some opinion may say about an entirely different circumstance in a different trial. I am satisfied that no courts have held that one may consent to maps being withdrawn at the end of the trial, directly or inferentially, and nevertheless thereafter successfully complain about such withdrawal. A very interesting question [39] would have been presented if the defendant at the time of admission had objected to a later withdrawal of these maps. This court would then be required to decide whether the Army was so deprived of the right to protect its secrets that it would have to allow anyone charged with being a conspiring traitor to go scott free or publish the things that he was charged with attempting to betray. But that question is not before me. There was no objection at all.

I do not, of course, know whether the then Captain Romero was actually guilty or not of the offense charged. He knows. An examination of the record, however, has surprised me with the extraordinary care that the court martial took to accord the defendant a fair trial. No short trial can be conducted without some mistake being made. I do not think anyone would contend that any court could go through a trial producing a record as large as this without making some ruling concerning which some other court might have a different view. I doubt that many trials indicate any more desire to give the

defendant a fair trial than this record indicates. I am not unmindful of the fact that the defendant has in his statement advised this court that the maps were of absolutely no importance and were of the kind that were used for wrapping paper. Whether they were important or not were questions for the court martial. They are military men. They would know much more about that than in the Philippines than I, thousands of miles away, would know now. The undisputed evidence, as I read it, shows that they were regularly kept in a locked receptacle and shows that the defendant took the trouble to photograph them. The members of the court martial may not have been very much impressed by a contention that a Captain of the ability of this Captain and of his education would photograph wrapping paper. [40]

The petitioner has also urged that because he was a Filipino he was not given a fair trial. Doctor Lazatin, a Filipino, testified that the defendant's wife had attempted to induce him, because he was a friend of the defendant, to perjure himself. This Filipino doctor stated that because he was a Filipino he was "ashamed to mix with this case; besides that I cannot betray my country testifying to what is not true." Such indicates the attitude of the patriotic Filipinos.

The American people have a very high regard for the people of the Philippine Commonwealth. That they should have a high regard for them is demonstrated by the very brave fight the Filipinos have

been putting up against great odds. The forces of the Philippines have demonstrated a willingness to fight for liberty such as many peoples of Asia have not shown.

The West Point education of the petitioner a number of years ago and his promotion, as well as the entrusting to him of the Army secrets would indicate that the Army personnel also has consistently had a high regard for the people of the Philippine Islands.

These later comments of mine have no vital part in the decision. If I felt that the defendant were innocent but also believed that trial requirements had been complied with I would still be compelled to dismiss his petition now. I am satisfied that the requirements were complied with. I think anyone reading the record impartially would come to the conclusion that it is not surprising at all that the then defendant was found guilty. If actually he were not guilty it is very tragic and unfortunate that he chose to put himself in the position where the circumstances seemed so strong against him. Mr. Semsem has most ably presented the contentions of his client. He was confronted with the obstacles [41] of what the record actually disclosed. If the petitioner had a civilian attorney and no other counsel and if such civilian counsel had been excluded for a while from the proceedings Mr. Semsem would have had a very much more favorable case. Likewise, if the then defendant had objected to the proviso that the maps were to be later re-

moved Mr. Semsem would have had very much more of an opportunity now to get the result he seeks. I think I have covered all the matters presented to me.

The petition is denied and dismissed. Mr. Semsem?

Mr. Semsem: Your Honor, I would like to have an appeal noted.

Judge Black: All right, you may have an exception to the ruling, and of course, will be given an opportunity to appeal.

Mr. Shucklin: Would it be possible to have Your Honor's remarks transcribed so that we could prepare findings?

Judge Black: I had not made my remarks with the idea that they would be transcribed. This is an oral opinion. The language of it is, of course, probably not as apt on many questions as it ought to be. I have not cited cases because I felt the facts differentiated this situation from any of the cases mentioned by counsel on either side. I know of no case that was at all like this.

Mr. Shucklin: I know that Mr. Semsem wants to get back to Washington, D. C. and I was just wondering whether or not we should prepare findings before he leaves.

Judge Black: Mr. Semsem has waited quite a while. The importance of this question would have justified a written decision. I did not get this official record until just the other day. I gave an oral decision so that he might have the privilege of going east. You may send him the findings which [41a] you prepare. He may mail such objections as he

has. The findings should not be entered until he has an opportunity to protect the record for his appeal. I do not see why Mr. Semsem should not proceed east. He stated in open court the other day that he was willing for me to announce my decision after he left but I did think it was preferable to have him present.

Mr. Semsem: I am willing to file my notice of appeal before I leave.

Judge Black: I rather doubt the advisability of that before the findings are signed. I think such would be premature. It would be my guess that the safe plan for you to follow is to give notice of your appeal after the court has signed the order or judgment of dismissal. If you think differently you should, of course, follow your own judgment. But I think waiting to appeal until I sign the dismissal is the safer plan for you. Certainly, I will not sign any dismissal until I am satisfied you have been notified of the time it is going to be presented so you can speedily present any notice of appeal.

Mr. Semsem: I will send my notice of appeal when the dismissal then is signed.

[Endorsed]: Filed May 2, 1942. [42]

In the United States District Court, Western District of Washington, Southern Division.

RECORD OF PROCEEDINGS:

At a regular session of the United States District Court for the Western District of Washington, held

at Seattle, in the Northern Division thereof, on the 12th day of June, 1942, the Honorable Lloyd L. Black, U. S. District Judge, presiding, among other proceedings had were the following, truly taken and correctly copied from the Journal Record of said Court, to-wit:

Cause No. 370

[Title of Cause.]

RECORD OF PROCEEDINGS.

On this 12th day of June, 1942, Findings of Fact and Conclusions of Law and Order of Dismissal are presented to the Court by Gerald Shucklin, Assistant United States Attorney, and the said Findings of Fact and Conclusions of Law and Order of Dismissal are at this time signed by the Honorable Judge Lloyd L. Black.

A True Copy:

Attest:

JUDSON W. SHORETT,
Clerk.

[Seal] By E. REDMAYNE,
Deputy. [43]

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above matter coming on regularly before the Court, the petitioner herein having been represented

by Pedro P. Semsem, and the respondent, P. J. Squier, Warden of the United States Penitentiary on McNeil Island having been represented by his attorneys, J. Charles Dennis, United States Attorney, and Gerald Shucklin and Oliver Malm, Assistant United States Attorneys, and the Court having heard and considered the testimony herein and having heard and considered the arguments of the counsel for the respective parties, now makes the following

FINDINGS OF FACT

I.

That on October 30, 1940 the petitioner was charged with violation of the 96th Article of War, before a general court martial which was convened at Fort William McKinley, Philippine Islands, under four specifications of conspiracy to unlawfully communicate certain maps marked "Secret" to certain persons not entitled to receive such information, and unlawfully reproduce certain maps marked "Secret". That the petitioner entered a plea of not guilty to said accusations and was tried before the said general court martial, and was later found guilty thereunder and on November 25, 1940 was sentenced to serve fifteen years at hard labor. That said sentence was later confirmed by the President of the United States on July 5, 1941 and that the place of petitioner's [44] confinement was directed by General G. C. Marshall, on July 8, 1941 to be the United States Penitentiary at McNeil Island, Washington.

II.

That at all times during said trial the petitioner was represented by counsel of his own choosing; that at the petitioner's request, he was represented there by military counsel as his chief counsel and by civil counsel as his associate counsel. That associate defense counsel for the petitioner was absent during a portion of the said trial proceedings, without objection being made by petitioner or his other defense counsel; that the petitioner's military counsel was at no time excluded from said trial.

III.

That certain evidence obtained under a search warrant issued by the Justice of the Peace of the town of Pasay, Province of Rizal, Philippine Islands, was introduced at the said trial without objection being made thereto by the petitioner or his defense counsel; that at the said trial counsel for the prosecution and the defense stipulated that said search warrant was legal, and petitioner in the record stated he understood that stipulation.

IV.

That, whereas petitioner has here asserted that he was entrapped and induced by Government witnesses to violate the law and was arrested for doing what he was solicited by them to do; there was a conflict of evidence introduced in the trial before the court martial upon the question of entrapment, which question was there resolved against the petitioner. [45]

V.

That, whereas petition has here asserted that the record of the proceedings before said court martial was and is insufficient for the reason that it does not contain exhibits II to XVIII thereof, that is, certain maps, when said maps were introduced counsel for the prosecution specifically stated that said exhibits were secret maps and were to be later withdrawn from the record, and defense counsel neither objected to the introduction of said exhibits, nor objected for the reason that they were later to be withdrawn.

From the foregoing Findings of Fact the Court now makes the following

CONCLUSIONS OF LAW

I.

That the petitioner received a just and fair trial before the general court martial; that said general court martial had jurisdiction of the petitioner and of the offenses there charged against him and had jurisdiction to impose said sentence of imprisonment upon the petitioner, and that said sentence was and is in all respects valid and binding, and petitioner is not now unlawfully restrained and detained by the respondent.

II.

That petitioner was not denied the right to be represented in said court martial trial by counsel of his own choosing, and that petitioner's constitutional rights were in no manner violated in said court martial trial.

III.

That petitioner has failed to establish grounds

upon which he is now entitled to be released from his present confinement at the United States Penitentiary at McNeil [46] Island, Washington, and that his petition for writ of habeas corpus and release from confinement should be denied.

Done In Open Court this 12th day of June, 1942.

LLOYD L. BLACK,

United States District Judge.

Presented by:

OLIVER MALM

GERALD SHUCKLIN,

Asst. U. S. Attorney.

Copy received and approved as to form this 25th day of May, 1942.

PEDRO S. SEMSEM,

Attorney for Petitioner.

[Endorsed]: Filed June 13, 1942. [47]

[Title of District Court and Cause.]

ORDER OF DISMISSAL

The above entitled matter coming on regularly to be heard upon motion of the counsel for the respondent, petitioner being represented herein by Pedro Semsem and respondent being represented by his attorneys, J. Charles Dennis and Gerald Shucklin and Oliver Malm, Assistant United States Attorneys and the Court having heretofore made and entered its findings of fact and conclusions of law herein, in accordance therewith, it is now hereby

Ordered that the petition of the petitioner herein by and the same is hereby denied; that the above entitled action be and the same is hereby dismissed, and it is further

Ordered that the petitioner is remanded to the custody of the respondent, P. J. Squier, Warden of the United States Penitentiary at McNeil Island, to complete the service of the sentence imposed upon him by the general court martial at Fort William McKinley, Philippine Islands, as later approved.

Done In Open Court this 12th day of June, 1942.

LLOYD L. BLACK,

United States District Judge.

Presented by:

OLIVER MALM,

GERALD SHUCKLIN,

Asst. U. S. Attorney.

Copy received and approved as to form this 25th day of May, 1942.

PEDRO P. SEMSEM,

Attorney for Petitioner.

[Endorsed]: Filed June 13, 1942. [48]

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that Rufo C. Romero, petitioner above-named, hereby appeals to the United States Circuit Court of Appeals for the Ninth Circuit, from the judgment entered in this petition on 1942.

Dated 1942.

(Signed)

PEDRO P. SEMSEM,

Attorney for Petitioner.

Copy delivered to U. S. Attorney, Tacoma, Wash.
June 15, 1942.

E. REDMAYNE, Dep. Clerk.

[Endorsed]: Filed June 15, 1942. [49]

[Title of District Court and Cause.]

CLERK'S CERTIFICATE TO TRANSCRIPT
OF RECORD

United States of America,
Western District of Washington,
Southern Division—ss.

I, Judson W. Shorett, Clerk of the District Court of the United States for the Western District of Washington, do hereby certify and return that the foregoing Transcript of the Record on Appeal, consisting of pages numbered 1 to 58, inclusive, is a full, true and correct copy of so much of the record, papers and proceedings in Cause No. 370, entitled In the Matter of the Petition of Rufo C. Romero for a writ of Habeas Corpus, as required by Designation, and Supplemental Designation of Petitioner-Appellant and Supplemental Designation of Respondent-Appellee, on file and of record in my office at Tacoma, Washington, the same constituting the Transcript of the Record on Appeal from the Judgment of the District Court of the United States for the Western District of Washington, Southern Division, to the United States Circuit Court of Appeals for the Ninth Circuit.

I do further certify that Petitioner-Appellant's original Statement of Points and the original Court Martial proceedings are transmitted herewith.

I do further certify that the following is a full, true and correct statement of all expenses, fees and charges earned by me in the preparation and certifi-

cation of the said Transcript of the Record on Appeal, to-wit: [49]

Clerk's fee for preparing, comparing and certifying Petitioner - Appellant's portion of the Transcript on Appeal.....	\$6.05
Appeal fee	5.00
	<hr/>
	\$11.05

I further certify that the said fees, above set forth, have been paid in full by attorney for said Petitioner-Appellant.

In testimony whereof I have hereunto set my hand and affixed the seal of said Court, in the City of Tacoma, in the Western District of Washington, this 17th day of August, 1942.

[Seal] JUDSON W. SHORETT,
Clerk.

By E. REDMAYNE,
Deputy. [50]

TRANSCRIPT OF COURT MARTIAL
RECORD
REVIEW OF THE STAFF JUDGE
ADVOCATE

Staff Judge Advocate, Hq. Phil. Div., Fort William McKinley, P.I., January 11, 1941. To: The Commanding General, Hq. Phil. Div., Fort William McKinley, P.I.

1. The Record of Trial by General Court-Martial of the following named accused having been referred to me under the provisions of the 46th Article of War before action thereon by the reviewing authority, I submit herewith my review, with opinion and recommendation and reasons therefor, as required by paragraph 87*b* of the Manual for Courts-Martial.

2. Synopsis of the Record.

Romero, Rufo C., 018350, Captain, Philippine Scouts (CE), 14th Engineers (PS).

Tried at Fort William McKinley on November 25, 1940. Days awaiting trial: 40 (In confinement).

Age (nearest birthday): 33 years.

Appointed from: Philippine Islands.

Length of service: 9 7/12 years.

Previous convictions: None.

CHARGES

Violation of A. W. No. 96	Gist of Offense	Pleas Not Guilty	Findings Guilty
Sp. 1:	Communicating secret maps pertaining to national defense to persons not entitled to receive such information.	Not Guilty	Guilty
Sp. 2:	Reproducing uncensored "SECRET" maps of military installations without authority.	Not Guilty	Guilty
Sp. 3:	Conspiring to communicate secret maps pertaining to national defense.	Not Guilty	Guilty
Sp. 4:	Conspiring to reproduce uncensored "SECRET" maps of military installations without authority.	Not Guilty	Guilty

Sentence: "To be dismissed the service, to forfeit all pay and allowances due or to become due, and to be confined at hard labor, at such place as the reviewing authority may direct, for fifteen (15) years".

Maximum Punishment: In the discretion of the Court (A.W. 96).

3. Inquiry Into the Sanity of the Accused.—After arraignment, the defense made a motion that the court conduct an inquiry into the mental condition of the accused, with a view to determining whether or not the accused was competent to conduct or cooperate intelligently in his defense, and with respect to the offenses charged against him, whether or not at the time it is alleged the offenses were committed, he was able, concerning the particular acts charged, both to distinguish right from wrong and to adhere to the right (R. 11). The court having determined upon such an inquiry, the following evidence was offered:

a. Evidence.

(1) For the Defense.—The testimony of an older sister of the accused who took care of him in childhood establishes that as a child accused was "hot-tempered". When he was seven years old he had malaria. During his illness which lasted about six weeks he would shout very loud at night stating that he was frightened. Once he shouted and ran. When witness tried to catch him, he fell on the stairs (R. 24). He was unconscious and

bleeding from the head and nose. He was under medical care for about eight months. Although he sometimes shouted in his sleep, from that time witness noticed accused was all right. On one occasion, apparently about the same time, he poured a bottle of kerosene on the floor of the house and lighted it with a match. On another occasion he beat a boy who refused to go with him to get a cow. Four or five years ago accused threatened to shoot a man who remarked that accused was very fat. Accused had a caliber .45 pistol in his hand at the time. The man did not take the matter into court because witness told him accused was mentally unbalanced (R. 25, 26). (Upon examination by the court, witness testified that the incident in which accused threatened to shoot a man "was investigated by Major McKenzie at Camp Stotsenburg" (R. 38), and that the man dropped the case after witness told him accused was not really serious, and that he had a habit of being immediately hot-tempered at times (R. 39)). During the month of August, presumably of the present year, when witness failed to bring a brother from Capas to Manila accused walked along the roadway shouting for his brother (R. 30). In conversations with witness, accused become very angry and called her names (R. 30, 31). Because of his actions, a brother of the accused consulted a medical officer, who advised consulting a specialist (R. 31).

The housegirl of the accused, in his employ for

eighteen (18) days prior to his arrest, testified that every time the telephone rang, accused ran downstairs and hid in the dark room; when something did not please him at the dinner table he threw food and dishes on the floor; he beat his children without cause and scolded them (R. 40), after which he would cry. Accused rolled on the floor and always talked to himself. Witness thought accused was "crazy" (R. 41). In taking his bath, accused kept his pajamas or shirt on, and then proceeded to his room with wet clothes (R. 41, 42, 43). He would call to witness for dry clothes and when these were given to him, he would throw them back, bang the door and shout "God *dam*" or "God *dam* it" (R. 41, 42, 45). On one occasion accused scolded and shouted at his wife just as she was about to go out. When witness saw the wife upstairs later her clothes and hair were in a dishevelled condition and her left arm was sprained (R. 48).

Another housegirl in accused's employ for a month and a half, about October, 1940, testified that after beating his children, he would run downstairs and shout (R. 56). In other respects the testimony is similar to that of the previous witness.

Wife of the accused testified as to certain acts of uncivility, of wilfulness, of cruelty and obscenity, on the part of the accused (R. 62, 64, 66, 67), as well as peculiar behavior at certain times, described as "tantrums" and "fits" (R. 62, 64, 67). The accused showed fear of the telephone especially

within the few months preceding trial, and got worse after witnesses informed accused that G-2 was after him and the Constabulary was watching him (R. 68). Also, during this period, people were calling accused attempting to collect debts (R. 70). Witness never thought to go to Army medical authorities with a view to determining accused's mental condition, as he would be sane for months at a time, but did talk to Mariano Lazatin, a civilian doctor, about the accused, the last time about three months prior to trial, and this doctor said accused was "crazy" (R. 73, 85). Several months previous accused insulted Major Guevara by hanging up the receiver on the telephone while conversing with Major Guevara (R. 81, 82).

(2) For the Prosecution.—Doctor Mariano Lazatin testified that on the morning of November 7th, Mrs. Romero called at his office and asked witness to testify that he had treated accused about four or five months previous, when as a matter of fact the doctor had never treated the accused (R. 94-97, 110). Witness was a townmate of accused and knew him for two or three months before accused left for the United States, about eighteen years ago, and also subsequent to his return from the United States but never noticed any signs of insanity, or abnormality (R. 95, 96, 111). The wife of the accused never spoke to witness or consulted him about her husband's mental condition (R. 99, 110), but a month previous to her last visit she brought a check for twenty

pesos to witness and asked him to cash it which he did (R. 100). The check was returned the following day by the bank and witness turned it over to his attorney (R. 100, 101). The accused later left twenty pesos and a note stating he was angry for the action taken but witness did not get angry with accused (R. 102, 103).

Upon recall for further cross-examination, Mrs. Romero testified that she saw Doctor Lazatin the day before and "asked him come * * * and asked him if he would remember the things he told me and he repeated them to me * * *". Witness saw Doctor Lazatin after she talked to him three months before, but did not talk about accused at all (R. 113).

Colonel Stickney, Corps of Engineers, under whose command accused served for about one year, testified that he had been in contact with accused for three or four years prior to July, and had had three or four sketchy contacts with him since July (R. 120). Accused never showed any signs of abnormality or insanity, or came to his attention in that regard. In his opinion, the accused was sane and knew the difference between right and wrong up to the time he last saw him, about June 1st. (R. 121). Accused was investigated several times, chiefly on matters involving debts, and in one instance about a quarrel with a retired soldier (R. 123). Accused showed no abhorrence for answering the telephone while he was on duty in witness' headquarters (R. 124). At the suggestion of the

witness, the wife of the accused once came to his quarters relative to financing her trip home from a fund available to a group of ladies, after hearing rumors that the wife had left the accused. The wife of the accused stated that although she wanted to go home, she was afraid to take any steps to go home because she was afraid of physical violence (R. 127, 131).

Lieutenant Colonel Skerry, commanding officer of the accused, who had known him for a very short time, saw him for ten minutes on October 15th during an inspection by the Department Inspector General. Accused reported to the inspector in a military manner, and answered questions of the Inspector accurately, and exceedingly well. He was calm, keen and very collected. He appeared to be normal (R. 132-134). Witness again saw accused on morning of October 16th, at which time he told him he was to be assigned to duty as Topographical officer. Accused was in complete possession of his faculties (R. 134). Witness gave the accused permission to absent himself the entire day to clear up his debts. Shortly after giving such permission the accused reported that unless he were made Assistant to the Division Engineer he could not handle the secret maps. Witness informed him he did not plan to make him Assistant to the Division Engineer (R. 135).

Major Evans, whose only contact with the accused occurred on October 16th, when he saw him for about three hours, testified that on that occa-

sion he had opportunity to observe him closely. He took him into custody in the name of the Commanding General. The accused reacted normally under the circumstances (R. 141). After being warned of his rights by Colonel Baehr, who, at the time of the trial was not available as a witness, witness heard accused state, among other things, that his trouble was all due to becoming heavily indebted through gambling (R. 143). His remarks at this time clearly indicated to the witness that he knew the difference between right and wrong (R. 142). Accused exhibited definite agitation, but his remarks were coherent (R. 145). Witness granted a request of the accused, made after his arrest, that he be not left in the house where his children, upon their return, would see him, and permitted him to enter witness' car (R. 146). On the way to Fort McKinley, accused asked witness to permit him to attempt to escape so witness could shoot him, because he would be better off dead (R. 145, 146).

Lieutenant Colonel Seeley testified that he had frequent official contact with the accused during the preceding three years. Accused's conduct and his use of the telephone in witness' presence were normal (R. 148, 149). In his opinion the accused knew the difference between right and wrong in his official business (R. 150, 151).

Lieutenant Page, 14th Engineers, who knew accused since October, 1938, and had official contact with him since March, 1940, testified that he had

never seen the accused exhibit any characteristics which could be classified as abnormal. Witness saw the accused answer the telephone but never saw him exhibit any emotion or fear in answering the telephone. He never saw accused in a fit (R. 152, 153, 155). As adjutant of the 14th Engineers, the accused came to his attention officially on accused's private financial affairs, but not with regard to his relations with members of his family (R. 157, 158).

Major Manzano, who knew accused intimately for previous six years and was officially associated with him for four years (R. 159), testified that on one occasion about October 8th or 9th, after witness had secured shelter for Mrs. Romero at the home of witness' sister, partly due to apprehension for her safety, the accused called on him to find out the whereabouts of his (accused's) wife, who had left and taken all the money necessary to pay his official bills. Accused threatened to commit suicide and to wipe out his whole family if necessary if he could not locate Mrs. Romero that night (R. 163, 166, 168), and also threatened to kill anybody that he felt was hiding his wife. At the time, the accused showed witness a box containing a white powder, claiming it was cyanide (R. 166). From his contact with the accused, he did not believe accused to be insane (R. 164). During his relationship with accused, the latter reacted slightly more violently during periods of stress and strain than the average person (R. 170).

Major Cowles, who knew accused very well for preceding two and one half years, and who investigated the charges against the accused, testified that during the investigation lasting from October 20th to about October 30th accused was present in his office every morning and under his observation for a period of twelve to fifteen hours. The accused was aware of the proceedings taking place, appeared to follow intelligently the course of the investigation, whenever he desired to do so, but manifested an attitude of indifference throughout the investigation. Witness believes accused was sane and knew the difference between right and wrong (R. 170-172).

Major Glattly, Medical Corps, registrar of the hospital at Fort William McKinley, testified that the official records of the accused covering the period October 21, 1931 to October 28, 1939, did not indicate that the accused had ever been reported as having any form of insanity (R. 174, 175). The records in question show observations for short periods of time, none of which, however, were sufficient to determine the presence or absence of mental disorders (R. 176).

b. Additional Evidence.—The Court having decided adversely to the accused on the issue of sanity based upon the foregoing evidence, the defense, during the trial, offered to adduce further evidence relative to the accused's mental condition (R. 426), and toward the close of the session on November 20, 1940, presented a witness as to the mental

condition of the accused with a request that the question of sanity be reopened (R. 532). The court having determined upon a further inquiry the following additional testimony was offered toward the conclusion of the trial:

(1) For the defense.—Doctor Antonio Vasco, a general practitioner, who knew accused a long time and his family very well, testified that he observed the accused on two occasions for a total period of about one hour and ten minutes (R. 589, 594, 595, 603). Upon the first occasion, he went to observe the accused at the instance of his brother. He asked accused “How are you?” and accused answered him in a loose manner and told him he was disgusted with his family. Witness did not want to mix himself up because he thought it was a family matter. One day accused came to witness’ house. While they were talking, accused, without justifiable cause, left without saying good-bye and that attitude struck the witness as strange (R. 590, 591, 595). As a result of these personal observations of the accused witness believed accused suffers a mental deficiency or mental alteration (R. 590, 594). He believed there were moments when accused could not distinguish right from wrong and there are times accused is capable of adhering to the right (R. 594). Witness made no psychiatric examination and was merely stating his superficial observations. Witness would not state it as his positive opinion that accused was suffering from mental deficiency (R. 602).

(2) For the Prosecution.—Captain Ernest H. Parsons, Medical Corps, after being qualified before the court as a psychiatrist, testified as follows: He met the accused twenty months ago and saw him on half a dozen occasions. On one of these he had a meal or two with him and talked to him casually for some moments at each meal (R. 608). As a result of his observations he could not render an opinion as to the mental deficiency or the mental health of the accused (R. 609). However, as the accused was a graduate of the United States Military Academy, and assigned to the Corps of Engineers witness was of the opinion he could not be a mental defective. As to his mental health it would take witness at least thirty days to render an opinion (R. 609). Five or six hours would be necessary to diagnose mental deficiency (R. 609, 610). This could not be done by talk and observation but requires one of the well standardized tests, such as the “I.Q.” or Army “Alpha” and “Beta” tests (R. 610). True psychoses are not consistently normal every morning and frequently abnormal after work hours. Psychotic cases do, however, become more evident under stress, such as performing military duties or other arduous work, than during periods of rest (R. 616).

c. Findings.—Upon the conclusion of the evidence in 3a, above, the court decided adversely to a ruling of the law member that the court should adjourn for the purpose of making a report in pursuance of paragraphs 63 and 35c of the Manual

for Courts-Martial, and found that the accused was competent to conduct or cooperate intelligently in his defense, and with respect to the offenses charged against him, at the time these alleged offenses were committed, he was able concerning the particular acts charged, both to distinguish right from wrong and to adhere to the right (R. 184, 186).

Upon conclusion of the evidence in paragraph 3b, above, the court found that the accused was free from mental defect, mental disease or mental derangement at the time of the commission of the alleged offenses; that he was able concerning the particular acts charged both to distinguish right from wrong, and to adhere to the right, that he was at the time of this finding free from mental disease and mental derangement; and that he was able to cooperate intelligently with his counsel in his defense (R. 617).

d. Opinion.—In my opinion the action of the court in not sustaining the ruling of the law member referred to in 3c, above, was proper, and the findings of the court are legally sustained by the evidence. The report referred to by the law member is not mandatory but is left to the discretion of the court (par. 65, M.C.M.). The testimony of the witnesses for the defense shows that both as a child and as an adult the accused was quick-tempered and insisted upon having his own way, especially with those in his home, or those of inferior station (R. 24, 37, 40, 62). All of the acts of the accused relied upon by the defense as

showing that the accused was insane, and not otherwise explained, may be attributed to these traits of the accused's character. There is, however, nothing in the evidence to indicate that this disorder of personality amounted to insanity or prevented the accused from both knowing the difference between right and wrong and adhering to the right. On the contrary, the testimony of witnesses for the prosecution shows that when the accused came in contact with those upon whom he could not impose his will, he was capable of exercising self-restraint, and that during such periods knew the difference between right and wrong and could adhere to the right. Captain Parsons testified that true psychoses are not thus consistently normal in the morning and abnormal after work hours (R. 616).

Moreover, during the period of about fourteen days covering the trial of the case the accused was under the observation of the court for approximately sixty hours. In addition to making an unsworn statement, he actively and intelligently cooperated in his defense on many occasions, both during the inquiry into his sanity and during the trial on the general issue (R. 81, 102, 114, 259, 297). Professor Wigmore commenting upon this type of evidence states as follows:

“ ‘To a rational man of perfect organization’, said a Kentucky judge just a century ago, ‘the best and highest proof of which any fact is susceptible is the evidence of his own

senses. Hence autopsy, or the evidence of one's own senses furnishes the strongest probability and indeed the only indubitable certainty of the existence of any sensible fact.' The advantage of this proceeding—the tribunal's own view of a thing shown to it, or autoptic proference, as we may now call it—is that the tribunal is saved from having to cogitate over the possible inferences from circumstantial evidence * * * or from testimonial assertions * * *. (Wigmore on Evidence (Students' Textbook, 1935) sec.206).

In view of the foregoing I am of the opinion that the evidence establishes the mental responsibility of the accused beyond a reasonable doubt, and that consequently the court was justified in its findings on this issue.

4. General Issue.

a. Evidence.

(1) For the Prosecution.—The substance of the evidence for the prosecution establishes that on October 15th and 16th 1940, the accused, a Captain in the 14th Engineers, was, among other duties, Assistant to the Division Engineer, having automatically resumed this duty on his return from leave October 15th. He was originally assigned to this duty in July, 1939, by authority of Division Headquarters. As Assistant to the Division Engineer he was custodian of secret maps and documents in possession of the 14th Engineers and

therefore charged with accountability of all secret documents and maps issued by the Department Engineer to the Division Engineer as a Special Staff Officer of the Division (R. 199, 200, 347). Under regulations in effect on October 12, 1940, and received by the Division Engineer on October 16, 1940, the Commanding General, Philippine Division, was the person to give authority for the reproduction of secret documents by members of the Division Engineer's organization. Instructions to reproduce secret maps came directly to the Division Engineer. In reproducing such maps he was assisted by the 14th Engineers. Under regulations in existence prior to receipt of the regulations dated October 12th, the Assistant Chief of Staff, G-2, of the Philippine Department was the person to give authority for the reproduction of secret matter, and the Department Engineer was the agency to reproduce it. The Division Engineer had no instructions to reproduce maps on the 15th and 16th of October, 1940, and gave no authority to anybody to reproduce maps on those days (R. 200, 201). Secret maps of the 14th Engineers and those held under the authority of the Division Engineer were stored in a large double-padlocked box in the map section of regimental headquarters, 14th Engineers, at Fort William McKinley (R. 203). Censored maps have indicated thereon a statement that the map has been censored by authority of the party censoring it, and the undesirable information, secrets, or designs on the map

is deleted therefrom (R. 204). Although rather exceptional, maps may be reproduced by photography (R. 205). Exhibits Nos. 3 to 10, inclusive, withdrawn after trial, were properly introduced and identified by the Division Engineer as seven uncensored maps and one uncensored overlay classified under existing regulations as "Secret" pertaining to the defense of the Philippine Islands (R. 204, 205). Exhibit No. 11 was identified as a photographic negative of a map showing roads and trails, corrected to February 6, 1939, of an area including the southern tip of Bataan, including the Island of Corregidor. Exhibits Nos. 12 to 18, inclusive, were identified as photographic negatives of six secret maps and one secret overlay of a map. The Division Engineer did not authorize anyone to communicate the maps, of which these negatives were reproductions, to Mariano Cabrera and Anis Y. Gepte (R. 204-206), nor were they entitled to receive the information contained in the maps or overlay on or about October 15, 1940 (R. 212).

The evidence further establishes that on or about October 5, 1940, in a conversation with Anis Y. Gepte, a secret operative of the Philippine Army, detailed on work to check Fifth Column activities (R. 265), one Ignacio Agbay, an employee of the City of Manila (R. 215), who had known Gepte for about three months as the son of a prominent Datu in Mindanao and had been introduced to him as Datu Ding, (R. 235), told Gepte, hereafter re-

ferred to as such, that if he wanted to make money, he had a plan which he would introduce to him; that there was a certain map indicating the defense plan which they might sell to the Japanese at a good price. Agbay told him that "the maps will be taken by one of his friends through an officer of the United States Army". Gepte replied that he had friends who might buy them and would look for prospects. Three days later Gepte informed him that he had such a prospect, the Sultan of Mindanao, (a fictitious person, (R. 264)) and asked him for the map, but Agbay stated he could not contact the man with the map that day (R. 215, 216, 236). On the afternoon of October 11th, Agbay introduced Gepte to one Mariano Cabrera who told him he had the map ready at any time if an agreement could be reached (R. 217). Gepte informed Cabrera that he would have to see the Sultan. On October 12th, Gepte met Agbay and Cabrera and told the latter that the Sultan instructed him that "if they are really on the business, they should show him any maps". Later Cabrera showed him a map of Lingayen Gulf marked "Restricted" and permitted him to take it until the next day stating he could furnish any map of the Philippine Islands. Exhibit No. 2, withdrawn at the conclusion of the trial, was identified by Gepte as looking like the "Restricted" map of Lingayen Gulf given him by Cabrera (R. 217, 218, 219). Gepte took the map to an official of the Philippine Army, who, in turn, took Gepte to Major

Evans, G-2, United States Army, where Gepte reported what Cabrera had told him. Major Evans told him to ask Cabrera for the maps of Corregidor, Manila Bay and Channel, Disposition of Troops in Bataan, Philippine Department Defense Plan. At the same time Gepte was turned over to Major Evans until the conclusion of the case (R. 272).

After leaving the house of Major Evans, Gepte returned the blueprint of Lingayen Gulf to Cabrera, asking him for the maps indicated by Major Evans (R. 219, 220). About October 14th after Cabrera gave him a list of four maps stating the total price of (pesos) 65,000, Gepte told him he was going to see the Sultan (R. 220). Later that day Gepte saw Agbay and told him he had informed the Sultan the price was (pesos) 95,000 instead of (pesos) 65,000. Agbay thereupon proposed that they tell Cabrera that the Sultan bargained for (pesos) 45,000, and that they (apparently Gepte and Agbay) would split the (pesos) 55,000 [sic]. Cabrera was informed that the Sultan would pay (pesos) 40,000 to which he agreed. On October 15th, Cabrera informed Gepte that since the business was finished, Captain Romero, the principal, wanted to see him (R. 220, 221). By previous arrangement Gepte met Agbay and Cabrera at the London Restaurant between 5:00 and 5:30 P.M. on October 15th, (R. 225, 268) after which Gepte and his son joined Agbay, Cabrera, the accused, and Mrs. Romero and proceeded in accused's car to Luneta Boulevard. Gepte and Agbay wore white

suits and Cabrera white pants and a brown camisa (R. 225). Upon reaching Luneta Boulevard, Mrs. Romero suggested that they talk the matter over at Captain Romero's house, located at 100 Del Pan, Pasay, [Rizal, P.I.] to which place the party then proceeded, where a further discussion took place, during the course of which the accused informed Gepte that they would go over to Fort McKinley that night in order to make the maps.

About 7:15 P.M., after having supper together, the party departed for Fort McKinley, where the car was parked in front of and across the street from the building containing the regimental headquarters, 14th Engineers (R. 226, 227, 228, 204, 268, Exhibit 1). The accused, Cabrera and Gepte crossed the street, proceeded up the right stairs and after the accused unlocked the door they entered the building, proceeding next to a room containing a safe. While Gepte held a flashlight the accused opened the combination safe, from which he took a "bundle" of keys. They then went to another room on the opposite side of the building where the accused unlocked a chest on the floor and took out of this chest a bundle of maps. They next proceeded to a room which was inside this big room, and which the accused stated was the dark room. At this point the accused placed the bundle of maps on the tables and after ordering Cabrera to put on the light, explained to Gepte and Cabrera about defenses and plans and many things that referred to defenses and plans. The

accused showed them maps. One of these was a map of Corregidor and the accused also mentioned Mariveles and Bataan, emphasizing the mark "Secret" and "Restricted" stamped on each map (R. 228-230, Exhibit 1). Among other things, the accused explained many things about Corregidor, told them Mariveles was a very important defense, and showed Gepte the symbol for a gun emplacement (R. 240, 241). He also talked of national defense, pointing out on the maps places and troop locations (R. 256). These explanations were made to both Gepte and Cabrera (R. 259). The accused told Gepte that since it would take two or three hours to do the mapping and departure from the building too late at night would make somebody suspicious, it would be advisable for him to make the maps at his house the next day. The accused further informed him that he would take the maps the following day from Fort McKinley and photograph them at his house at 100 Del Pan, Pasay, because by giving him the negative, "millions of copies" could be made. Accused then put the maps in the "big chest" and went to the safe and locked it. The party then returned to the accused's house about 8:30, the accused taking with him a roll of paper and Cabrera two bottles containing a liquid, which they had brought from the accused's house, for use in making the photograph of the map (R. 230, 269). Exhibits 3 to 10, inclusive, were identified by Gepte as looking like the maps that were shown him by the accused on

the night of October 15 at Fort McKinley (R. 231, 232). Upon return of the party to the house of the accused, they talked about the price, and the accused asked for (pesos) 50,000. Gepte told him he would take the matter up with the Sultan.

After further negotiation, the accused, at about 11:00 A.M. on October 16th, telephoned Gepte that he was going to get the maps about 1:00 P.M. and that he would start photographing them about 2:00 P.M., and asked him to come to his house at once. The accused told Gepte at this meeting of his distrust in him, and that if he were a person of the law and the case came before the proper authorities, he (accused) would be accused of a crime more serious than murder. Gepte replied that if anything happened he would not go back to Mindanao but would prefer to commit suicide, to which accused replied that he would proceed with the transaction, and that he trusted him. At 2:30 P.M. Gepte accompanied the accused and Cabrera to a dark room in the basement of the accused's house, where the latter and Cabrera placed three trays containing colored liquid on the table, turned off the lights, and started the developing (R. 232, 233, 250). After about an hour, someone turned on a light and there were eight negatives in the trays (R. 250, 251). The accused then said he was finished with the developing and showed Gepte four negatives, which were still a little wet, through a light. The latter identified Exhibits 11 to 18, inclusive, as looking like the negatives that were

shown him in the dark room in the accused's house (R. 234, 235), and further identified the negatives shown him by the accused as representing maps similar to the ones shown him at Fort McKinley on October 15, 1940 (R. 252). Gepte suggested to the accused that the negatives be placed in order with the original maps in such a way that when he (Gepte) returned with the Sultan, they could check them immediately and leave the place as soon as possible. The accused agreed (R. 235, 259).

While the events indicated above were taking place, Major Evans, Assistant to the Assistant Chief of Staff G-2, Philippine Department, to whom Gepte had previously given information to the effect that he had been approached by a representative of the accused, made arrangements for searching the residences of the accused and Cabrera (R. 273).

At about 4:30 P.M. on October 16th, a Constabulary party, accompanied by Major Evans, and armed with a search warrant, which was properly introduced in evidence, read into the record, and a certified copy of which is attached and marked Exhibit 20, raided the residence of the accused at 100 Calle Del Pan, Pasay, Rizal, in one room of which they found the accused and Cabrera, and eight photographic negatives, apparently drying, all of them reproductions of secret maps, as well as several rolls of classified maps and overlays (R. 273, 274, 290, 293, 294). In the basement a dark room indicated recent use (R. 274, 299, 309), and an assortment of

photographic materials was found therein (R. 308, 309). Certain other classified documents were found in the automobile of the accused (R. 274, 299). Ignacio Agbay was discovered about to leave the house by the rear stairway (R. 299). Major Evans took possession of all the maps and photographic negatives so as to prevent other members of the raiding party from seeing them, and also took custody of the accused (R. 274, 300). He later delivered the documents to Lieutenant Colonel Harland F. Seeley, Assistant G-2, Philippine Division (R. 279). Exhibit No. 2 was identified by Major Evans as the restricted map of Lingayen Gulf Area shown him by Gepte (R. 280). Exhibits 3 to 10, inclusive, were identified by Major Evans, by his *initals* placed on each, and Exhibits 11 to 18, inclusive, by distinctive clippings at the corners which he made himself, as the maps and negatives which he found in the raid on the accused's residence (R. 281-283). Major Evans testified that there was no authority for the communication of these maps to Mariano Cabrera or Anis Y. Gepte. There was no authority given to the accused by the office of the Assistant Chief of Staff G-2, Philippine Department, which coordinates and supervises reproduction of maps to reproduce these maps or any other maps on October 16th (R. 284). Simultaneously with the raid described above, a party from the Philippine Constabulary headed by Lieutenant Villafria, Philippine Constabulary, executed a search warrant in the house of Cabrera, finding therein among other things, a restricted map

of Lingayen Area. Lieutenant Villafria identified Exhibit No. 2 as the restricted map of Lingayen found in Cabrera's house (R. 312, 313). Exhibits 3 to 10, inclusive, were identified by Lieutenant Colonel Harland F. Seeley, Assistant to the Assistant Chief of Staff G-2 and 3, Philippine Division, (R. 337), by the initials placed on them by Major Evans in his presence, as the maps and overlay, given him by Major Evans on the night of October 16, 1940. He also testified that the maps are classified as secret and so marked. Exhibits 11, 12, 13, 14, 15, 16, 17, and 18, in turn, were identified by the same witness as reproductions of Exhibits 3, 4, 5, 6, 7, 8, 9, and 10, respectively, and by the clipped corners on each, as the negatives turned over to him on the evening of October 16th (R. 325, 333). The maps were continuously in his possession from the time of their receipt from Major Evans until they were turned over to the Trial Judge Advocate of this court (R. 334). All authorizations for the reproduction of the maps in evidence came through the Assistant to the Assistant Chief of Staff G-2 and 3, Philippine Division, under direction of the Division Commander, who is also the Commanding General, Fort William McKinley (R. 337, 334). The accused had no authority from anyone at Headquarters, Philippine Division, to reproduce these or any other maps on or about October 16, 1940 (R. 333).

The accused, after having been warned that he need not answer any question or make any statements, but that if he did so, what he said might be

used against him, admitted to Colonel Baehr, G.S.C., then Acting Commanding Officer, Fort William McKinley, that he was involved seriously as to his personal finances, that he had been tempted to divulge secret information, from which he could expect to receive financial return (Exhibit 19).

Lieutenant Myron B. Page, Jr., 14th Engineers, whom the accused relieved as Assistant Division Engineer on October 15th, was still signed up for secret maps on that date and still had access to the map case. The accused had proceeded to check secret maps on the morning of that date, assisted by Master Sergeant Delda, 14th Engineers, preparatory to transfer of accountability therefor (R. 347, 363). While the accused was engaged in checking the maps, Sergeant Delda told him there were certain maps which had to be returned to the Department Engineer (R. 363). After the accused's departure about 12:50 P.M., October 15th, Lieutenant Page, upon instructions from the Assistant to the Assistant Chief of Staff G-2, Philippine Division, made a check of secret maps but none were missing (R. 347). Another check was made between 8:30 P.M. and 9:15 P.M. on that same day, but none of the maps were missing (R. 348). Lieutenant Page identified the figure 3 on Exhibit 1 as the location of the secret map chest (R. 352) and Exhibits 3 to 10, inclusive, as the maps detailed in the specifications of the charge (R. 353, 354). These specific maps were present at the check of the maps in the map chest made about 8:30 P.M., October 15, 1940 (R. 390). On the

night of October 15th there were two sets of keys to the map chest. One set was in possession of Lieutenant Page, and the other set was in the regimental safe (R. 352). Colonel Skerry, Major Manzano, Lieutenant Page and the accused were the persons having the combination of the safe on October 15 and 16, 1940 (R. 358). None of the maps in evidence were removed from the map chest between 7:30 P.M., October 15th, 1940, and 4:30 P.M., October 17, 1940, by Colonel Skerry, Major Manzano or Lieutenant Page, except that as indicated above, Lieutenant Page removed them temporarily for the purpose of checking maps, after which they were returned to the chest and securely locked (R. 383, 386, 390).

At about 7:45 A.M. on October 16th while all other officers were attending an officers' call, the accused, who had obtained keys to the map chest from Lieutenant Page for the purpose of continuing his check of secret maps, told Sergeant Delda to get out the maps that were supposed to be returned to the Department Engineer and place them on the drafting table (R. 348, 363). Exhibits 3 to 10, inclusive, were not among those to be so returned (R. 369). After the accused was through going over the maps he told Sergeant Delda to put back those he did not take. He also told Sergeant Dangoy, another non-commissioned officer, to wrap up what he was going to take along. He then departed in a taxicab, stating he was going to the Department Engineer (R. 363, 364). Sergeant Delda returned the keys to the map chest to Lieutenant Page about 8:15 A.M., during

officers' call (R. 349). A check of all secret documents at Regimental Headquarters, 14th Engineers, including secret documents in the safe, by Colonel Skerry, Major Manzano and Lieutenant Page, was commenced about 8:00 P.M., October 16th and continued most of the night (R. 349, 353). When discontinued both sets of keys to the map chest were locked in the safe and a guard was posted at regimental headquarters the rest of the night, and also during an alert held on the morning of October 17th as well as during lunch hour that day (R. 353, 391, 396). No one entered regimental headquarters while the guard was on duty on the night of October 16-17 until Colonel Skerry relieved him on the morning of October 17th (R. 395). No one opened the safe or the map chest during the period of the alert or during lunch hour on October 17th (R. 396). When the check of the secret map chest in regimental headquarters, 14th Engineers, was completed at 4:30 P.M. on October 17, 1940, the maps in evidence were missing from the map chest (R. 355, 391, 392), and later found to be those in the possession of Colonel Seeley (R. 392).

The evidence further establishes that about the early part of September, the accused consulted a technician of the Kodak Philippines, Ltd., Manila, P.I. relative to equipment for photographic reproduction of maps (R. 569, 570, 579, 586). On September 7, the Kodak Philippines, Ltd., Manila, P.I., delivered to the accused certain items of photographic equipment, billed to the Post Exchange Nichols Field

(R. 571, 572, Exhibit 21). The film in this list was suitable for reproduction of line work, i.e., printed matter, pencil and ink sketches, drawings and maps, but not portrait work. Being panchromatic film, it is capable of reproducing colors when used with the proper filters (R. 572). Exhibit 17 (photographic negative) was identified by a photographer of the Kodak Philippines, Ltd., as film that would fit the camera sold on the invoice to the Post Exchange, Nichols Field, and delivered to accused, and suitable for reproduction of maps or for lithography (R. 582, 583).

Anis Y. Gepte, the principal witness for the prosecution, testified that he never made any promises to Agbay that would lead the latter to believe he was working for him on this case against the accused; and that he never promised him that he would get a job as detective or investigator if he helped him on the case, or told him there would probably be a Government reward in this case and he would share in it if he helped on the case, nor did he offer Cabrera any reward for helping him on the case (R. 412, 413).

(2) For the Defense.—So far as it can be pieced together, the testimony of Ignacio Agbay, an alleged co-conspirator of the accused, who was duly warned of his constitutional rights in the premises before he testified and several times during his testimony (R. 404, 405, 410, 430, 444), is in substance as follows: He first met Gepte on September 15, 1940, and knew him as Datu Ding. He met him again at the London

Restaurant about the 10th of October (R. 433). At this time he knew Gepte was a Constabulary informer as the latter had told him so on their first meeting (R. 442). In their conversation he "unconsciously" told Gepte about certain plans, consisting of house plans and blueprints, one of the latter being a map of Lingayen Gulf, which the accused had entrusted to his (Agbay's) friend Mariano Cabrera, who had told him about the plans in his possession about eight months before (R. 454, 455, 462, 463, 474, 478). Gepte told him if he would work with him, under his instruction, he would give witness "thousands" in cash out of a reward from "the Government", as well as a recommendation for a position as secret service man or agent of the Philippine Constabulary in the event they were successful on the case he was after, which was a frame-up case on the accused, whom witness did not know at the time (R. 447, 452). This frame-up involved the sale of plans (R. 454). As Assistant to Gepte, Agbay was to introduce him to accused using Cabrera as intermediary (R. 451, 452, 455). In accordance with the agreement he made with Gepte, he had Cabrera introduce him (and apparently Gepte also (R. 461)) to the accused about 5:00 o'clock on the afternoon of October 15th (R. 461, 465), but mentioned nothing to Cabrera, his friend of seven or eight years standing, about the plan to frame the accused (R. 464). The plan was to make Cabrera and the accused "believe that there will be a buyer of the plans in case those plans will be of value" (R. 467). (At another point

during his testimony witness testified he met accused once before the meeting on the 15th of October through Cabrera, in order to do a favor for a girl friend who was looking for a job (R. 474)). He had no idea the plans in Cabrera's possession had any value, and for that reason had never reported the matter to proper authorities (R. 484).

The substance of the testimony of Mariano Cabrera, another alleged co-conspirator of the accused, is as follows: He first met Gepte on October 13th through his friend Agbay (R. 511). At this meeting, after showing Gepte "the map", the latter told him that a Sultan wanted to buy maps and asked him if he could introduce them (evidently meaning Gepte and Agbay) to the accused (R. 512, 513). Witness thereupon grabbed the plans and maps and asked Gepte why he wanted him to do that when he was a "D. I." He knew Gepte was a "D. I." because when he met him on this occasion he saw "a whistle and a big knife" on his right side (R. 514). In a private conversation Gepte shortly after admitted to him he was a "D. I." (R. 514), and asked him to help in an investigation being made of the accused because of gambling (R. 525). Upon informing Gepte that he had had a quarrel with the accused about three or four days before, Gepte offered him 500 pesos out of a premium from the Government and promised to recommend him as a special agent. At the same time Gepte told him to follow every instruction (R. 524, 525). Witness was willing to lay a trap for the accused, whom he had known for more than three

years, because he could not forget the quarrel between the accused and himself, and because of Gepte's promise of a reward and his further promise that Captain Romero would not be harmed, but only discharged from the Army (R. 526). At this time witness and the accused were publishing a magazine. The accused was supervisor and planned to do the photography for the magazine (R. 526, 527). On the night of October 15th, he and Agbay met Mrs. Romero and the accused, who invited them to go to his house (R. 521). Later they went to the London Restaurant and picked up Gepte and his son and returned to the accused's house. After eating he, Mrs. Romero, Gepte, Agbay and son, and the accused drove to Fort McKinley (R. 504, 515), to enlarge pictures (R. 505). Witness sat in the front seat but could not remember who drove the car (R. 504, 505, 518, 519, 520). He did not know exactly why Gepte came along on this trip (R. 515, 516).

After the party arrived at Fort McKinley about 8:00 P.M., witness together with Gepte and the accused entered a building at Fort McKinley (R. 498). Upon entering this building, the accused turned on a light, and after opening a door on the left, turned off the light (R. 505). Witness, upon instructions from the accused, entered the dark room with chemicals and papers for enlarging pictures and negatives. The accused did not accompany him to the dark room (R. 499). Arriving in the dark room, he made preparations for the developing of pictures but discovered that one chemical was missing. As he was about

to go out he met Gepte and the accused at the door just as they were about to enter and told the accused that he was unable to proceed with enlarging pictures. The accused told him that they would do no more. Thereupon he returned to prepare the bottles, papers and negatives for their return. He did not see the accused carrying anything because it was dark outside the "dark room", but he could clearly see both Gepte and the accused, and would have known whether accused had maps in his hand because they were close together (R. 499, 500). (Witness later testified the accused and Gepte accompanied him to the dark room at first but left him. When he discovered the chemical was missing he came out to tell the accused, whom he observed talking to Gepte at the second door, outside the dark room (R. 501, 502). Although the light was off at the time he could notice them because of the window and because "they wore white cloth" (R. 507)). The witness estimated they were in the building about twenty minutes (R. 503, 504). He did not see the accused carry anything out of the building (R. 518). He did not help the accused with the photographic work or see any negatives the following day (R. 516, 527). When properly confronted with a signed statement made by him on October 16th, inconsistent with his testimony on this last matter, the witness offered the explanation that the statement was made under instructions of Gepte to give "any statement very good for him or for me", if he were forced to make a statement (R. 528, 530); also because Lieutenant Villafria, to whom he made

the statement, told him just to sign it and it would not harm him (R. 529).

The competent evidence of Antonio Garcia, relative to the credibility of Gepte, establishes that once in 1939, Gepte employed him temporarily as a police "especial". He gave him two cans of opium and told him to put it in the Chinese store of Ah-Gong and let him know where he put it, and that then he (Gepte), together with the Constabulary, would take the opium (R. 542, 545).

Anis Y. Gepte, the principal witness for the prosecution, admitted upon recross-examination that he had once been convicted of "estafa" (fraud) about twenty-five years ago when he was very young. This was known by the Philippine Army when he was employed as an investigator. Another case pending against him, partly connected with his duties, involves the shooting of a person. That happened while he was already employed by the Philippine Army (R. 411, 412, 422, 423).

The accused, after having his rights explained to him, elected to make an unsworn statement (R. 551-554). Insofar as it relates to denial, explanation or extenuation of the offenses charged against him, the statement, which includes a great deal of matter which is properly argument, is in substance as follows: He intended to return the maps presented in evidence, together with other obsolete maps, to the Department Engineer on the day following his arrest. He told Colonel Baehr that he was prepared to destroy the evidence in question after he accom-

plished his plan to teach his persecutors to leave him alone. The purpose of the visit to Engineer Headquarters was to enlarge some pictures, and Mr. "X" (Gepte) insisted on coming, according to him, in order to convince the Sultan that he had been to Fort McKinley (R. 555, 556). Mr. "X" saw no maps or blueprints at Engineer Headquarters (R. 557). He told Cabrera about his plans to surprise Gepte when he came back at 5:00 P.M. on October 16th, and sent his children to the beach in anticipation of his plans to end all the unnecessary snooping on him. He told Colonel Baehr and Major Evans that he was aware that Constabulary operatives were snooping on him for a long period (R. 562). It never entered his mind to communicate any secret information. He always kept many maps in his quarters or residence, as he worked on them at home. The map found in Cabrera's house was one of "those restricted blueprints Sergeant Delda said were usually used for wrapping or for scratch pad work". He never mentioned to any unauthorized person that he had custody of secret documents. He did not report the matter to the proper authorities because these were the ones bent on getting him. He made several reports of subversive activities that came to his attention. He raided a suspect himself and turned in his findings to his Commanding Officer (R. 563). This year he turned in an espionage report concerning Bataan and Olongapo. Even after his arrest he gave Major Evans intelligence he gathered that some nation already has secured a copy of every secret map we have (R. 564).

b. Opinion.

(1) In my opinion the findings of guilty are legally sustained by the evidence. Although Gepte, the principal witness for the prosecution, to whom it is alleged the accused communicated the maps set out in Specification 1, could not positively identify Exhibits 3 to 10, inclusive, as the maps which he saw at Fort William McKinley on the night of October 15, 1940, there is evidence to show that he asked Cabrera to get maps of Corregidor, Manila Bay and vicinity, disposition of troops at Bataan and the Philippine Department defense plan (R. 220). Gepte testified that on the visit to Fort McKinley the accused showed Cabrera and him certain maps, one of which was a map of Corregidor. While discussing this map he mentioned Mariveles and Bataan, and emphasized the marks "Secret" and "Restricted" on each map. He also explained defenses and plans and showed him a symbol for a gun emplacement (R. 229, 240). These circumstances coupled with the finding of the eight maps specified, together with the eight negatives of those maps, in the residence of the accused the afternoon following, justifies the inference that the accused communicated those particular maps to Gepte and Cabrera on the night of October 15th. Also, the finding of the eight maps, and the eight negatives of the same, at the house of the accused, when considered with the circumstances surrounding the events of the preceding evening justified the court in concluding that the accused in fact reproduced the maps as alleged in Specification 2.

The details of the evidence respecting the conspiracy to communicate and to reproduce maps, as alleged in Specifications 3 and 4, respectively, are so interwoven as to prevent any clear separation thereof. However, in my opinion, the evidence as the whole, with particular reference to the purposes of the conspiracy and the acts of the alleged conspirators preceding and following the meeting at the residence of the accused on the night of October 15th, establishes the essentials of both the conspiracy to communicate and the conspiracy to reproduce. Inasmuch as the offenses of the communication and of the reproduction of maps are, by statute, separate offenses from the conspiracy to commit such offenses (50 U.S.C. 31 (d), 45b; 18 U.S.C. 88), it cannot properly be said that the conspiracy to communicate or the conspiracy to reproduce merged in the corresponding completed crime (Miller, Criminal Law (1934) sec 13, 32 (d)). And in my opinion, upon similar reasoning, neither does the one conspiracy merge in the other.

Motive for the crimes is shown by the accused's admission to Colonel Baehr that he was seriously involved in his personal finances (Exhibit 19).

(2) Paragraph 3, Special Orders No. 45, Headquarters Philippine Division, dated November 4, 1940, details Lieutenant Colonel Emil C. Rawitser, Judge Advocate General's Department, Headquarters Philippine Department, as member and law member of the general court-martial appointed by paragraph 1, Special Orders No. 44, Headquarters

Philippine Division, dated October 30, 1940, for the trial of the accused (R. 1, 2). The record does not show that Lieutenant Colonel Rawitser was made available to the Commanding General, Philippine Division, for this duty. The records of this office show that the officer in question was in fact made available for this duty on November 1, 1940 by verbal instructions of the Commanding General, Philippine Department, which instructions were made of record by a letter to the Commanding General, Philippine Division, on the same date. It is not necessary that every fact essential to jurisdiction of a court-martial should be set out in the record in each case, but with respect to formal matters relating to the creation of the court there is a presumption of regularity (*McRae v. Henkes*, 273 Fed. 108 (C.C.A. 8th, 1921), cert. den. *Henkes v. McRae*, 258 U.S. 624 (1921); *Dig. Ops. JAG* (1921) p. 58). However, for your information and for the information of the confirming authority, there is attached hereto a copy of the letter, referred to above, making the services of Lieutenant Colonel Rawitser available for the duty in question.

(3) The reporter was sworn, and the Assistant Trial Judge Advocate announced the names of the members of the court present, before the announcement of the name of the accused and the introduction of counsel (R. 3). Although such procedure was irregular (par. 56 and Appendix 6, *M.C.M.* (1928)), in my opinion it did not injuriously affect the substantial rights of the accused.

(4) At the beginning of the trial the accused stated that he desired to introduce individual counsel, but in answer to the question whether he desired to have the regular defense counsel and assistant defense counsel sit as associates and collaborate with the civilian counsel, he replied "No. I want the regular detailed officers to conduct the defense and the civilian defense counsel [to] cooperate and act as associate counsel" (R. 4). The court granted the request of the accused and permitted Mr. Benjamin de Guzman to act as associate defense counsel.

Under A. W. 17 the accused had the right to be represented in his defense before the court by civilian or military counsel of his own selection, otherwise by the defense counsel duly appointed for the court pursuant to A. W. 11. Where the accused has counsel of his own selection, the defense counsel and assistant defense counsel, if any, of the court, are required, if the accused so desires, to act as his associate counsel (A. W. 17). By the request of the accused to have the defense counsel and assistant defense counsel conduct his defense, they became, in effect, military counsel of his own selection (par. 43b, M.C.M.). Except as noted above, there appears to be no provision for associate counsel, military or civilian. On the other hand, I have been unable to find any express prohibition against permitting an accused to be represented by such counsel. In my opinion the court, in the interest of the accused, properly granted the privilege, but subject to its restriction as circumstances might require.

(5) The record does not show that the question of challenge of one of the members of the court by the defense, for cause, was decided by secret written ballot (R. 93), as is expressly required by A. W. 31. However, it will be noted that this error has been corrected by the certificate attached to the record.

In this connection the record also shows that the challenged member resumed his seat before the court announced that the challenge was not sustained (R. 93). The irregularity, if any, does not injuriously affect the rights of the accused, since no proceedings intervened between the resumption of his seat and the announcement of the court on the challenge.

In a subsequent session, the prosecution suggested a further examination of the challenged member, mentioned above, in order to have him clarify his answers previously given upon examination as to his competency. The law member ruled that subject to the objection of any member of the court, a further examination could be made. A member having objected, the court was cleared and closed, the member who had been previously challenged also withdrawing from the court (R. 189). Although the challenge of the member was not sustained in the original proceedings on the question, the exclusion of the member was proper since, as stated by the court, the member was involved in the matter (See Dig. Ops. J.A.G. 1912-1930, sec. 1347 (2)).

(6) During the presentation of testimony relating to the secret maps offered in evidence, the court excluded, among others, all non-military personnel, including the associate defense counsel, a civilian. There was no objection by the accused, his defense counsel, assistant defense counsel, or the associate defense counsel to this ruling (R. 202 et seq).

In view of the opinion expressed in (4), above, and of the penalty provided in section 1 (d) of the act of June 15, 1915 (40 Stat. 217; 50 U. S. C. 31) as amended by the act of March 28, 1940 (Pub. No. 443, 76th Cong.), for the communication of maps, photographic negatives, plans, etc., relating to national defense to any person not entitled to receive the same, the court was justified in excluding the associate defense counsel. The substantial rights of the accused were not injuriously affected thereby, in view of the fact that he continued to be represented by counsel placed in charge of his case at his own request.

(7) During the trial the accused, through his defense counsel, requested that the court excuse the assistant defense counsel, Captain Ivy, during the remainder of the case, stating that the accused "feels a certain amount of antipathy against the Assistant Defense Counsel and feels that the Assistant Defense Counsel has a certain amount of antipathy toward the accused". There being no objection by any member thereof, the court, after asking the accused whether he requested any other

officer to assist in his defense and receiving a reply in the negative, excused Captain Ivy and directed him to withdraw (R. 224). The record fails to show that the assistant defense counsel withdrew.

The Manual for Courts-Martial (1928), does not specifically provide for the excuse of defense counsel (See par. 44b, M.C.M.) at the request of the accused (par. 43a, M.C.M.). However, paragraph 107b, Manual for Courts-Martial (1921) provides that if the accused, whether or not he has individual counsel, especially requests that the defense counsel or any particular defense counsel take no part in the case, the court will excuse him from attendance at the trial. The latter provision appears to have been omitted in the 1928 Manual, and to that extent is believed to be applicable to the present case (M.C.M. 1928, Introduction, p. vii). Accordingly, I am of the opinion that the action of the court in excusing the assistant defense counsel was proper.

The failure of the record to show the withdrawal of the assistant defense counsel has been corrected by the certificate attached to the record.

(8) At the beginning of the session of the court held on November 14, 1940, the president made the following announcement: "The court takes notice of the fact that the Associate Defense Counsel Benjamin D. de Guzman has withdrawn from the case" (R. 247). There is no affirmative showing that the withdrawal was with the consent of the

accused and the approval of the court. However, as to the former, the record discloses no objection by the accused or his defense counsel to the withdrawal and it is reasonable to presume from such omission that consent had in fact been given. As to the latter, there is no statute whereby a military court can compel the attendance of civilian counsel, particularly an associate civilian counsel for which there is no provision in the Manual for Courts-Martial (par. (4), *supra*), and whose original participation in the trial must necessarily have been permitted as an indulgence by the court. Hence, whatever may be the general rule in civil courts requiring the formality of express approval (7 C.J.S. 110), in the present case such action would have been superfluous. The accused continued to be ably defended by Major Johnston, the defense counsel in charge of his case, and no substantial right of the accused was injuriously affected by the withdrawal.

(9) Major Evans, a witness for the prosecution, was permitted to testify to a statement made to him by one of the alleged co-conspirators concerning the manner in which, and the purpose for which, the map found in the house of the co-conspirator by the Constabulary raid party came into his possession. So far as the record discloses, the statement was evidently made after accomplishment of the common design, and therefore was improperly admitted in evidence (par. 114c, M.C.M.). However, there was sufficient competent evidence to establish

both of the items referred to, and for that reason the improper admission of the statement did not injuriously affect any substantial right of the accused.

(10) Upon the recall of Ignacio Agbay as a witness for the defense, counsel stated that the attorney for the witness, Benjamin C. de Guzman was present in court and requested permission to be seated with the counsel for the defense during the interrogation of the witness (R. 427). The court permitted counsel for the witness to have a chair placed beside the witness and to advise the witness concerning his answers to questions, but instructed counsel that he would not be permitted to answer the questions for the witness (R. 428).

In my opinion the admission of counsel for the witness was a matter in the discretion of the court and subject to such conditions as it might impose (Winthrop, *Military Law and Precedents* (2d Ed. Reprint 1920) p. 167). However, the original conditions do not appear to have been appropriate tending, as the record discloses, to frequent promptings of the witness by his counsel, against which practice it became necessary to caution him (R. 440, 451), and ultimately to remove him from the side of the witness (R. 455). As indicated in the authority cited above, a better procedure would have been to permit counsel to be seated with counsel for the defense during the interrogation. However, the record shows that the court was ex-

tremely liberal in permitting the counsel to advise the witness, concerning the latter's answers to questions, throughout his entire testimony. In any event, no substantial right of the accused was injuriously affected by the action of the court.

(11) The accused and the defense counsel both contended that the accused was exempt from criminal liability because methods of entrapment or instigation were used for the purpose of detecting and apprehending him (R. 563, 622, 630). The evidence as to who provided the inducement or persuasion under which the accused acted in committing the alleged offenses is conflicting. Agbay testified that it was Gepte who made the original proposal to procure plans from the accused in order to trap him, after he happened to mention to Gepte certain maps which the accused had entrusted to his friend Cabrera. His testimony was in part supported by Cabrera. On the other hand, Gepte testified that Agbay suggested the plan to sell maps to the Japanese, and told him that the maps would be obtained through his friend Cabrera from an officer of the United States Army. The court apparently refused to believe the testimony of Agbay and Cabrera and chose instead to believe Gepte. In my opinion the court was justified in so doing. In his testimony Gepte denied that he had made any promises that would lead Agbay to believe he was working for him on the case against the accused, or ever promised him

a job or a share in a reward for helping him on the case. The record shows that Agbay was an unwilling witness and exhibited a marked lack of frankness while he was testifying. Cabrera's explanation that he was willing to frame the accused because of a quarrel with him does not appear plausible in the light of his association with the accused. In addition, there were certain discrepancies in his testimony, and he was shown to have previously made a statement inconsistent with his testimony on the stand, all of which make his testimony of doubtful probative value. The remaining evidence bearing on this point establishes that Cabrera showed Gepte the map of Lingayen Gulf as proof that he could get other classified maps, and permitted him to take it. Gepte later took the map to G-2, Philippine Department, and at this time he was turned over to G-2 until the completion of the case.

From the foregoing, I am of the opinion that the court was justified in reaching the conclusion that the inducement to commit the offense originated with Agbay or Cabrera. As neither of these persons was an officer of the law nor of the Government, nor acting in a representative capacity for them, the accused could not avail himself of the defense of entrapment (*Polski v. United States*, 33 Fed. (2d) 686 (C.C.A. 8th, 1929); *Miller, Criminal Law* (Ed. 1934) sec. 60). Nor, in my opinion, does the fact that Gepte later became a representative of the Government, and as such asked

Agbay and Cabrera to obtain certain other maps, alter this conclusion, since there was reasonable ground at that time to believe that the law was being violated or was about to be violated. Under those conditions he was justified in attempting to secure additional evidence that the accused was violating the law. (Casey v. United States, 276 U.S. 413 (1928); Miller, Criminal Law (Ed. 1934), sec. 59 (e)).

(12) There were some instances of the reception of hearsay (R. 324, 325) and conclusion (R. 336) testimony, but these irregularities were not such as to prejudicially affect any substantial right of the accused.

(13) It is my opinion that the record of trial is legally sufficient to support the findings of the court, and the sentence, and is free of any error injuriously affecting the substantial rights of the accused.

(14) By A. W. 96, the punishment is in the discretion of the court. In view of the penalties provided in sections 31 and 45 of Title 50 and section 88 of Title 18, of the United States Code, the sentence adjudged by the court is considered appropriate under the circumstances of the case.

Confinement in a penitentiary is authorized by A. W. 42 and section 335 of the United States Criminal Code (18 U.S.C. 541). Under current regulations of the Philippine Department, unless a penitentiary is designated, the place of confinement

for general prisoner, other than American general prisoners, is ordinarily the home station of such general prisoners (par. 73c, P.D.R., H.P.D. (1938)). Confinement in the Philippine Islands is not considered appropriate for the following reasons: (a) the announced policy of the War Department to separate general prisoners convicted of offenses punishable by penitentiary confinement from general prisoners convicted of purely military offenses, or of misdemeanors (par. 90a, M.C.M.); and (b) the peculiar knowledge of the accused of the national defense plans and of the topography of Luzon, with the attendant opportunity, due to lack of facilities for proper supervision, of transmitting such information to persons unauthorized to receive the same.

In view of the above, it is believed a recommendation should accompany the action of the reviewing authority to the effect that, if the sentence is approved, a penitentiary in the United States be designated as the place of confinement.

5. Recommendation.—For the reasons above stated it is recommended that the sentence be approved and the record of trial be forwarded for action under the 48th Article of War. It is further recommended that a separate recommendation accompany the action to the effect that, if the sentence is approved by the confirming authority, a penitentiary in the United States be designated as the place of confinement.

A form of action, and a form of recommendation, designed to accomplish the action here recommended

are attached for your consideration, and for your signature on each in case it should meet with your approval.

6. The delay in returning this record was due to the lengthy and involved evidence and to the unusual number and nature of the legal questions presented therein, requiring consideration by this office in preparation of the review.

ALBERT SVIHRA,

Major, J.A.G.D.,

Division Judge Advocate.

1 Incl.—

Copy of Letter, 11-1-40.

Proceedings of a General Court-Martial which convened at Fort William McKinley, Philippine Islands, pursuant to the following orders:

HEADQUARTERS PHILIPPINE DIVISION

Fort William McKinley, P. I.

October 30, 1940.

Special Orders No. 44:

1. A general court-martial is appointed to meet at Fort William McKinley, P. I., at 1:00 p. m., on November 5, 1940, or as soon thereafter as practicable, for the trial of Captain Rufo C. Romero, Philippine Scouts, 14th Engineers (PS), only.

Detail for the Court

Colonel Clifford Bluemel, 45th Infantry (PS).

Colonel Seth H. Frear, PS (Sig C), Hq Phil Div.

Colonel William E. Brougher, 57th Infantry (PS).

Lieutenant Colonel Alfred S. Balsam, 12th QM Regt (Div) (PS).

Lieutenant Colonel John W. Thompson, 57th Infantry (PS).

Lieutenant Colonel James W. Callahan, Jr., PS, 45th Infantry (PS).

Lieutenant Colonel Edwin E. Aldridge, 57th Infantry (PS).

Lieutenant Colonel William F. Dalton, 57th Infantry (PS).

Lieutenant Colonel Donald Van N. Bonnett, 45th Infantry (PS).

Major John W. Irwin, 45th Infantry (PS).

Major Pembroke A. Brawner, 57th Infantry (PS), law member.

Major Narciso L. Manzano, PS, 14th Engineers (PS).

Major Santiago G. Guevara, PS, 45th Infantry (PS).

Lieutenant Colonel Lewis C. Beebe, 57th Infantry (PS), trial judge advocate.

Captain Edgar Wright, Jr., 45th Infantry (PS), assistant trial judge advocate.

Major Howard D. Johnston, 23rd Infantry Brigade (PS), defense counsel.

Captain James M. Ivy, 57th Infantry (PS),
assistant defense counsel.

By command of Major General Pratt:

C. A. BAEHR,

Colonel, General Staff Corps,
Chief of Staff.

Official:

Signed: CARL H. SEALS,

CARL H. SEALS,

Colonel, Adjutant General's
Department,
Adjutant General.

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HEADQUARTERS PHILIPPINE DIVISION

Fort William McKinley, P. I.

November 4, 1940.

Special Orders, No. 45:

Extract

* * * * *

2. Major Pembroke A. Brawner, 57th Infantry (PS), is relieved as law member only of the general court-martial appointed to meet at Fort William McKinley, P. I., by paragraph 1, Special Orders No. 44, this headquarters, October 30, 1940.

*Page numbering appearing at foot of page of original Reporter's Transcript.

3. Lieutenant Colonel Emil C. Rawitser, Judge Advocate General's Department, Headquarters Philippine Department, is detailed as member and law member of the general court-martial appointed to meet at Fort William McKinley, P. I., by paragraph 1, Special Orders No. 44, this headquarters, October 30, 1940.

4. Captain Victor R. Hirschmann, Medical Corps, 12th Medical Regiment (PS), is detailed as member of the general court-martial appointed to meet at Fort William McKinley, P. I., by paragraph 1, Special Orders No. 44, this headquarters, October 30, 1940.

By command of Major General Pratt:

C. A. BAEHR,

Colonel, General Staff Corps,
Chief of Staff.

Official:

CARL H. SEALS,
Colonel, Adjutant General's
Department,
Adjutant General.

Copy to:

Each Off

CG Phil Dept

CO 57th Inf

CO 12th Med Regt

Div JA

Off Div

Rec Div [2]

Fort William McKinley, P. I.
November 7, 1940.

The court met pursuant to the foregoing orders at 2:05 o'clock, P. M.

PRESENT

Colonel Clifford Bluemel, 45th Infantry (PS).

Colonel Seth H. Frear, PS (Sig C), Hq Phil Div.

Colonel William E. Brougher, 57th Infantry (PS).

Lieutenant Colonel Emil C. Rawitser, Judge Advocate General's Department, Headquarters Philippine Department (Law Member).

Lieutenant Colonel Alfred S. Balsam, 12th QM Regt (Div) (PS).

Lieutenant Colonel John W. Thompson, 57th Infantry (PS).

Lieutenant Colonel James W. Callahan, Jr., PS, 45th Infantry (PS).

Lieutenant Colonel Edwin E. Aldridge, 57th Infantry (PS).

Lieutenant Colonel William F. Dalton, 57th Infantry (PS).

Lieutenant Colonel Donald Van N. Bonnett, 45th Infantry (PS).

Major John W. Irwin, 45th Infantry (PS).

Major Pembroke A. Brawner, 57th Infantry (PS).

Major Narciso L. Manzano, PS, 14th Engineers (PS).

Major Santiago G. Guevara, PS, 45th Infantry (PS).

Captain Victor R. Hirschmann, Medical Corps, 12th Medical Regiment (PS).

Lieutenant Colonel Lewis C. Beebe, 57th Infantry (PS), Trial Judge Advocate.

Captain Edgar Wright, Jr., 45th Infantry (PS), Assistant Trial Judge Advocate.

Major Howard D. Johnston, 23d Infantry Brigade (PS), Defense Counsel.

Captain James M. Ivy, 57th Infantry (PS), Assistant Defense Counsel.

ABSENT

(None)

Katherine Mason was sworn as reporter.

The order appointing the court and the amending order were read by the Assistant Trial Judge Advocate.

The Assistant Trial Judge Advocate then announced the names of the members of the court present. [3]

The court proceeded to the trial of Captain Rufo C. Romero, O 18350, Philippine Scouts (CE), 14th Engineers (PS), Fort William McKinley, P. I.

Assistant Trial Judge Advocate: The accused is present in court represented by the Defense Counsel and Assistant Defense Counsel. Does the accused desire to introduce Individual Counsel?

Accused: I do.

Assistant Trial Judge Advocate: Does the ac-

cused desire to have the regular Defense Counsel and Assistant Defense Counsel sit as associates and collaborate with the civilian counsel?

Accused: No. I want the regular detailed officers to conduct the defense and the civilian defense counsel cooperate and act as Associate Counsel.

Assistant Trial Judge Advocate (To Accused): You want the civilian counsel to act as associate and assistant to the regular detailed Defense Counsel and Assistant Defense Counsel?

Accused: Yes, sir.

President: Before we proceed the court desires that the names of the Defense Counsel, Assistant Defense Counsel and Associate Counsel be put into the record.

Associate Counsel: For the purpose of the record, I wish to give my name. It is Benjamin C. De Guzman, 15 Cementina, Pasay, Philippine Islands.

President (To Assistant Trial Judge Advocate): For the purpose of the record, Captain, we want it stated that the accused introduced as [4] his Defense Counsel, Major Howard D. Johnston, 23rd Infantry Brigade (PS); as Assistant Defense Counsel, Captain James M. Ivy, 57th Infantry (PS); and as Associate Counsel, Mr. Benjamin C. De Guzman, Manila, Philippine Islands.

Assistant Trial Judge Advocate: It has already been shown. — Copy of the charges in this case were served on the accused on the 31st day of October, 1940, at the Station Hospital, Fort William McKinley, Philippine Islands. You, Captain

Romero, are entitled to a copy of the record in this case without cost. Do you desire a copy of the record of trial?

Accused: Yes, sir.

Assistant Trial Judge Advocate: The accuser in this case is Lieutenant Colonel Harland F. Seeley, 57th Infantry (PS). The charges were investigated by Major E. R. Cowles, 57th Infantry (PS), and were forwarded by him directly to the Commanding General, Philippine Division. The Trial Judge Advocate at this time does not expect to call any member of the court now present as a witness for the prosecution in this case except Major Manzano, nor is any member the accuser. If there is any member of the court who has formed an opinion concerning this case, or who knows any of the material facts, or who, for any other reason, believes himself disqualified or is aware of any fact which might cause either the defense or the prosecution to challenge him, it is requested that he so announce in order that he may be excused or challenged.

Major Manzano: I am the accused's commanding officer in the 14th Engineers and as a member of the Regimental Staff I have taken part in certain preliminary investigation concerning this case and I have formed an opinion. [5]

Law Member: Does the defense wish to make any comment on that?

Defense Counsel: No, sir. The defense understands.

Law Member: Does the Trial Judge Advocate wish to make any comment?

Prosecution: It is the opinion of the Trial Judge Advocate that Major Manzano should be excused because he will be called as a witness in all probability.

Law Member: Major Manzano is excused from sitting as a member of the court in this case.

(Major Manzano withdrew)

Assistant Trial Judge Advocate: The Trial Judge Advocate does not desire to challenge any member for cause nor to exercise the right to one peremptory challenge. Have the accused's rights of challenge been explained to him by counsel?

Defense Counsel: Yes. The accused does not desire to exercise his right of challenge either for cause or peremptorily and is satisfied with the court as now constituted.

Assistant Trial Judge Advocate: Does the accused desire such rights further explained to him in open court?

Accused: No, sir.

Assistant Trial Judge Advocate: Captain Romero, are you satisfied to be tried by the court as it now sits?

Accused: Yes, sir.

The members of the court and the personnel of the prosecution were then sworn. [6]

The accused was then arraigned upon the following charge and specifications:

Charge: Violation of the 96th Article of War.

Specification 1: In that Captain Rufo C. Romero, Philippine Scouts, (CE), 14th Engineers (PS), an officer having access to secret maps pertaining to the national defense, to wit: Corregidor and Mariveles Vicinity (File No. 31 NE Copy No. 25); Tactical disposition of troops on Bataan, (File No. HI 7552-0176 Copy Numbers 307, 322, 424 and 452); Entrance to Manila Bay (File No. 31 Copy No. 1023); Traffic Circulation Map of Bataan (Copy No. 18) and Overlay No. 1 showing Defense Plan (File No. ODE 1228 copy No. 40), did, at Fort William McKinley, P.I., on or about October 15, 1940, willfully and unlawfully communicate the said maps to Mariano Cabrera and Anis Y. Gepte, persons not entitled to receive such information.

Specification 2: In that Captain Rufo C. Romero, Philippine Scouts (CE), 14th Engineers (PS), did, at Pasay, Rizal, P.I., on or about October 16, 1940, unlawfully reproduce certain official maps, marked "SECRET", of military installations, to wit: Corregidor and Mariveles Vicinity (File No. 31 NE, Copy No. 25); Tactical disposition of troops on Bataan (File No. HI 7552-0176 Copy Numbers 307, 322, 424 and 452); Entrance to Manila Bay (File No. 31 Copy No. 1023); Traffic Circulation Map of Bataan (Copy No. 18) and Overlay No. 1 showing Defense Plan (File No. ODE 1228, Copy No. 40), without first obtaining permission from the Commanding General, Fort William McKinley, P.I., or higher authority, said maps having no clear indication thereon that they had been censored by proper military authority.

Specification 3: In that Captain Rufo C. Romero, Philippine Scouts, (CE), 14th Engineers (PS), an officer having access to secret [7] maps pertaining to the national defense, to wit: Corregidor and Mariveles Vicinity (File No. 31 NE, Copy No. 25); Tactical disposition of troops on Bataan (File No. HI 7552-0176 Copy Numbers 307, 322, 424 and 452); Entrance to Manila Bay (File No. 31 Copy No. 1023); Traffic Circulation Map of Bataan (Copy No. 18); and Overlay No. 1 showing Defense Plan (File No. ODE 1228 Copy No. 40), did, at Pasay, Rizal, P.I., on or about October 15, 1940, conspire with Mariano Cabrera and Ignacio Agbay to unlawfully communicate the said maps to Anis Y. Gepte, a person not entitled to receive such information and to effect the object of said conspiracy did, thereafter on said date, in company with the said Anis Y. Gepte, visit the building at Fort William McKinley, P.I., in which the said maps were stored.

Specification 4: In that Captain Rufo C. Romero, Philippine Scouts, (CE), 14th Engineers (PS), did, at Pasay, Rizal, P.I., on or about October 15, 1940, conspire with Mariano Cabrera and Ignacio Agbay to unlawfully reproduce certain official maps, marked "SECRET", of military installations, to wit: Corregidor and Mariveles Vicinity (File No. 31 NE, Copy No. 25); Tactical disposition of troops on Bataan (File No. HI 7552-0176 Copy Numbers 307, 322, 424 and 452); Entrance to Manila Bay (File No. 31 Copy No. 1023);

Traffic Circulation map of Bataan (Copy No. 18); and Overlay No. 1 showing Defense Plan (File No. ODE 1228, Copy No. 40), without first obtaining permission from the Commanding General, Fort William McKinley, P.I., or higher authority, said maps having no clear indication thereon that they had been censored by the proper military authorities, and to effect the object of said conspiracy, did, on or about October 16, 1940, remove said maps from their place of storage at Fort William McKinley, P.I. to his home in Pasay, Rizal, P.I.

(Signature of accuser)

HARLAND F. SEELEY

Harland F. Seeley,

Lieut. Colonel,

57th Infantry (PS). [8]

AFFIDAVIT

Before me, the undersigned, authorized by law to administer oaths in cases of this character, personally appeared the above-named accuser this 28th day of October, 1940, and made oath that he is a person subject to military law and that he personally signed the foregoing charges and specifications, and further that he has investigated the matters set forth in specifications 1, 2, 3 and 4 of the Charge, and that the same are true in fact, to the best of his knowledge and belief.

(Signature) CARL H. SEALS

Carl H. Seals,

Colonel, AGD, Adjutant.

JA 201 Romero, Rufo C. 1st IND.

Headquarters Philippine Division, Fort William
McKinley, P.I.,
October 30, 1940.

Referred for trial to Lieut. Col. Lewis C. Beebe,
57th Infantry (PS), Trial Judge Advocate, General
court-martial appointed by paragraph 1, Special
Orders No. 44, Headquarters Philippine Division,
Fort William McKinley, P.I., October 30, 1940.

Employment of reporter is authorized.

By command of Major General PRATT:

(Signed) CARL H. SEALS

Carl H. Seals,

Colonel, AGD,

Adjutant General.

Prosecution: At this time has the accused any
special pleas?

Defense: The defense states at this time that the
accused has no special pleas to offer, but in view of
the matter contained in [9] Paragraph 63, Page 49
of the Manual for Courts-Martial and in Paragraph
78 (a), Page 63 of the same authority, the defense
moves that the court conduct an inquiry into the
mental condition of the accused, with a view to de-
termining whether or not at the time it is alleged
these offenses were committed, the accused was able
concerning the particular acts charged both to dis-
tinguish right from wrong and to adhere to the
right. In support of this motion, if the court so
directs, the defense will introduce witnesses whose

testimony it is believed will be relevant to the matter.

President: The court will be closed.

(The court was cleared and closed and upon being opened, the following proceedings were had:)

President: The reporter will read from the record the motion made by the defense.

(The reporter read from the record as requested)

Defense: May it please the court, the defense wasn't quite able to follow that statement. I believe the motion was incorrectly recorded and with the court's approval, I will read the motion again.

President: In future, when the defense or the Trial Judge Advocate has something they are going to read, it will be an advantage if a copy can be furnished the reporter.

Defense: I have prepared this in writing with that in mind. I intended to furnish the reporter with this.

President: The Counsel for the Defense may re-read his statement. [10]

Defense: The motion made by the defense was as follows: That the court conduct an inquiry into the mental condition of the accused, with a view to determining whether or not the accused is competent to conduct or cooperate intelligently in his defense, and with respect to the offenses charged against him, whether or not at the time it is alleged

these offenses were committed, he was able concerning the particular acts charged both to distinguish right from wrong and to adhere to the right.

President: The accused is authorized to introduce evidence to sustain this motion.

Prosecution: May it please the court, before the accused introduces evidence to sustain the motion, the prosecution would like to have a copy of the statement submitted by the Defense Counsel.

Defense: The defense has submitted no statement. The defense feels that it is in its place to present a motion at this time. It feels that it is a subject into which the court should inquire. For that purpose it has made this motion, but so far as a statement is concerned, the defense has made no statement in argument or evidence. Perhaps I misunderstood the Trial Judge Advocate.

Prosecution: I understood that a copy of the remarks made by the Defense Counsel was prepared with a view to submission to the reporter.

Defense: I have here the motion introduced, in writing.

(Trial Judge Advocate examines written motion.)

Prosecution: Does the court desire that the defense produce evidence to sustain this motion? [11]

President: It is the court's desire. [12]

Prosecution: The prosecution has one further request. The prosecution requests permission of the court in its discretion that Fiscal Dinglasan be permitted to hear these proceedings and be present in

court. Fiscal Dinglasan is the United States Attorney in Manila—the Commonwealth attorney in Manila. The Associate Counsel for the accused is also the Individual Counsel for the co-accused—Cabrera—in this case. In the interest of the United States, it is requested that this Fiscal Dinglasan be permitted to be present whenever the Associate Counsel is present. [19]

Fort William McKinley, P. I.,
November 8, 1940.

The court met, pursuant to adjournment, at 8:06 o'clock, A. M., all the personnel of the court, prosecution, and defense, who were present at the close of the previous session in this case, being present except:

Benjamin C. De Guzman, Associate Counsel.

The accused, the reporter and the witness were also present.

Member of the Court: May it please the court, in order to expedite the proceedings, I withdraw the motion I made just prior to adjournment yesterday.

President: Is the prosecution ready to proceed?

Prosecution: The interpreter was delayed a few minutes and is now on his way over.

President: The court will take a short recess.

The court then, at 8:08 o'clock, A. M., took a recess until 8:15 o'clock, A. M., at which time the personnel of the court, prosecution and defense, and the accused and the reporter resumed their seats. The Associate Counsel, the interpreter and the witness were also present.

Prosecution: The Trial Judge Advocate is ready to proceed.

President: Is the defense ready to proceed?

Defense: Yes, sir. The defense had concluded the examination of the witness on the stand at the time of adjournment yesterday. [36]

MRS. LORRAINE B. ROMERO

Redirect Examination

Questions by Accused:

Q. Did I ever insult Major Guevera on the telephone? A. Yes, you did.

Q. Please tell the court.

A. He insulted Major Guevera. (To Major Guevera) That was several months ago when he insulted you over the telephone. I remember that.[81]

The court then, at 5:20 o'clock, P. M., November 8, 1940, adjourned until 7:45 o'clock, A. M., November 9, 1940.

LEWIS C. BEEBE,

Lieutenant Colonel, 57th Infantry (PS),

Trial Judge Advocate.

Fort William McKinley, P. I.

November 9, 1940.

The court met, pursuant to adjournment, at 7:50 o'clock, A. M., all the personnel of the court, prosecution and defense, who were present at the close of the previous session in this case, being present except:

Benjamin C. De Guzman, Associate Counsel.

The accused and the reporter were also present.

President: It is noticed the Associate Counsel for the Defense is absent. Does the defense desire to make any comment on the absence of the Associate Counsel?

Defense Counsel: No, sir. The defense is ready to proceed. [119]

President: Proceed.

Prosecution: I desire to read from United States Code Annotated, Title 50, Section 45; from Executive Order of the President, March 22, 1940, defining certain vital naval and military installations and equipment, found in United States Code Annotated, Title 50, Section 45; from Title 50, Section 45 (b); from Title 50, Section 31, Subparagraph (d); and from Title 18, Chapter 4, Page 125, Section 88. The reading need not be recorded.

(The Trial Judge Advocate then read, in the order named, as above-indicated)

Prosecution: Does the court desire any additional law read? If not, the prosecution is ready to proceed with the introduction of evidence.

President: The prosecution may proceed.

Prosecution: Before proceeding, however, the prosecution would like to have the court take judicial notice of the contents of Army Regulations 380-5, which are the existing Regulations, dated June 10th, 1939, governing the safeguarding of military information.

Law Member: The court will take judicial notice

of Army Regulations 380-5 with respect to the subject referred to by the Trial Judge Advocate.

Prosecution: The prosecution also would like to have the court take judicial notice of Paragraph 43 (b) of Philippine Department Regulations, as amended by letter, Headquarters Philippine Department, dated October 12, 1940. These regulations prescribe who may reproduce secret or confidential maps. [193]

Defense Counsel: The defense would like to know the date of receipt of the amendment referred to.

Prosecution: Before going into that matter, the prosecution believes it should be read into the record—the paragraph which was in effect prior to the publication of the change dated October 12th, and that the change dated October 12th should also be read into the record.

Law Member: Subject to objection, the court will not take judicial notice of that Regulation and letter.

President: The Defense Counsel asked a question. I do not recall having heard it answered. Will the Judge Advocate answer it?

Prosecution: The prosecution stated that that matter would be brought out at the proper time. The Judge Advocate is not competent to testify as to what time any person received any given item.

President: Proceed.

Prosecution: The prosecution requested that these Regulations be read into the record—extracts

mentioned from Philippine Department Regulations.

Law Member: They may be read, subject to objection.

President: They may be read into the record.

(The Assistant Trial Judge Advocate then read as follows:) [194]

“PHILIPPINE DEPARTMENT
REGULATIONS
1938

HEADQUARTERS PHILIPPINE
DEPARTMENT
Manila, P. I.

October 1, 1938,
(OFFICERS DIVISION COPY)

* * *

SECTION VIII
CORPS OF ENGINEERS

“43. Maps and Mapping.—(AR 100-15; 330-5; 600-700)

“a. Classification of maps and aerial photographs.—In accordance with instructions in AR 330-5 and the approved policy for the classification of maps and aerial photographs in the Philippine Islands, military maps and aerial photographs are classified as Secret, Confidential, and Restricted. The Assistant Chief of Staff, G-2, this Headquarters, is charged with

the classification of all maps and aerial photographs. When maps and photographs have been once classified the Department Engineer, the Department Air Officer, and the commanding general, Harbor Defenses of Manila and Subic Bays, are authorized to authenticate the classification of all maps and aerial photographs in the Philippine Islands.

“b. Reproduction of secret or confidential maps.—The reproduction by any means whatsoever of a secret or confidential map by any person or agency other than the Assistant Chief of Staff, G-2, this Headquarters, The Department Engineer, or the commanding general, Harbor Defenses of Manila and Subic Bays, is prohibited. When secret or confidential maps are reproduced, in whole or in part, by the commanding general, Harbor Defenses of Manila and Subic Bays, that officer will furnish the Assistant Chief of Staff, G-2, this Headquarters, with two (2) copies of the map reproduced for file with the General Staff map collection maintained in his office.”

Assistant Trial Judge Advocate: Opposite that on that page in the margin, there is this notation in ink: “Rescinded by Ltr. HPD dated Oct. 12/40 (300-4)”. This is the letter rescinding this paragraph:

(Assistant Trial Judge Advocate then read the following:) [195]

“HEADQUARTERS PHILIPPINE
DEPARTMENT

Office of the Department Commander
Manila, P. I.

In reply
refer to:

300-4 Misc-AG

October 12, 1940.

Subject: Changes in Philippine Department Regulations.

To: All Post, Camp, Station and Depot Commanders.

“1. Pending revision of Philippine Department Regulations 1938, the following changes are announced.

“a. Paragraph 43 is rescinded.

“b. Section XVI is added as follows:

SECTION XVI

99. MAPS, MAPPING AND AERIAL
PHOTOGRAPHS.

(AR 300-15; 380-5; 600-700; FM 30-20; FM 30-21)

* * *

“b. Reproduction of Secret or Confidential Maps and Aerial Photographs.—The reproduction by any means whatsoever of a secret or confidential map or of a secret or confidential aerial photograph by any person or agency other than the Assistant Chief of Staff, G-2, this Headquarters, the Department Engineer,

The Commanding General, Philippine Division, the Commanding General, Harbor Defenses of Manila and Subic Bays, and the Commanding Officer, Nichols Field is prohibited. When new secret or confidential maps or secret or confidential aerial photographs are made by any office authorized to do so above, the office will furnish this Headquarters with two (2) copies of the map or photograph reproduced for file with the General Staff map collection maintained in the office of the Assistant Chief of Staff, G-2, this Headquarters.

* * *

By command of Major General Grunert:
(Signed) C. W. CHRISTENBERRY,
C. W. CHRISTENBERRY
Lieut. Colonel, A. G. D."

Prosecution: The prosecution is ready to proceed with the introduction of evidence.

President: Will any of this evidence be of such a secret nature that it will be necessary to exclude the spectators? [196]

Prosecution: Yes, sir.

President: Before any witness is brought on the stand in which the prosecution is aware that the witness will give testimony of a secret nature, the court will be advised in order that the spectators and all nonmilitary personnel may, if it is deemed necessary, be removed from the courtroom and the building.

Prosecution: The prosecution requests a one-minute recess.

President: The court will take a five-minute recess.

The court then, at 9:18 o'clock, A. M., took a recess until 9:25 o'clock, A. M., at which time the personnel of the court, prosecution and defense, and the accused and the reporter resumed their seats.

Prosecution: It is requested that all spectators be excluded from the courtroom at this time, in view of the nature of the evidence about to be offered.

President: Does that include all nonmilitary personnel?

Prosecution: No, sir.

President: All spectators will be excluded from the courtroom.

(The court was cleared)

President: Before any testimony is given, does the defense desire to have any pertinent law or regulations read?

Defense Counsel: May it please the court, the defense does not desire any matter read from pertinent law or regulations. The defense is ready to proceed with the trial. [197]

President: In connection with the remaining nonmilitary personnel in the court, I will read from Army Regulations 380-5, Paragraph 4 (c):

(The President then read as follows:)

“Oral Discussions. Classified Military Information.—Either public or private discussion of classified military information by members of

the military service with or in the presence of unauthorized personnel, is strictly forbidden.”

Also from the same Army Regulations, an extract from Paragraph 8 (g):

“Subject: Dissemination of Secret Matter.”

I will read the entire paragraph:

“Dissemination of secret matter will be held to the absolute minimum. Information as to contents or whereabouts of secret matter will be disclosed only to those persons whose duty requires such knowledge. It is exclusively for the official use of the person to whom divulged or issued, and who will be responsible for its safe custody or security. Its inviolability is the duty and responsibility of all persons having knowledge thereof, no matter how obtained.”

There remain in the court a few nonmilitary personnel. Is the testimony to be presented of such a character that they should be excluded at this time?

Prosecution: Not just at this time.

President: The prosecution will inform the President prior to any such testimony, in order that all may be excluded. Proceed with the examination. [198]

President: The reporter will read the last statement made by the Judge Advocate.

(Reporter read from the record as requested.)

President: All civilian personnel and all Military Police will leave the courtroom. Before leaving, I understand Major Taylor, the Provost Marshal Offi-

cer, is in charge of this prisoner. Major Taylor will remain in the courtroom as his immediate guard. The Military Police will be posted around the building.

(All civilian personnel then withdrew, including the following: Benjamin C. De Guzman, Associate Counsel; Fiscal Dinglasan, Spectator by permission of the court; Katherine Mason, Reporter; All Military Police.

The court then, at 10:07 o'clock, A. M., took a recess until 10:17 o'clock, A. M., at which time the personnel of the court, the prosecution and the defense (less Benjamin C. De Guzman, Associate Counsel), and the accused (with Major Taylor as guard), and the reporter (Sergeant John C. Gamble), and the witness, took their seats. [202]

The President called the Court to order, after recess, at 10:15 A.M.

John C. Gamble, R-3003311, Sergeant; Chemical Warfare Section, Detachment, Division Headquarters and Military Police Company (PS), Philippine Division; Fort William McKinley, P. I.; was duly sworn as reporter.

President: While waiting for all non-military and unauthorized personnel to be removed, Major Irwin will search the upper floor of the building to make sure that no one can listen in on the proceedings of this Court.

Major Irwin left the room and returned shortly.

Major Irwin: The Associate Defense Counsel has left this floor of the building. A civilian is in

the back wing of the building . One M. P. is on the top stairway. I would recommend that this M. P. be placed with the civilian witness in the north wing of this floor.

President: The Judge Advocate will arrange to adopt these suggestions and search the floor.

The Trial Judge Advocate left to carry out the instructions of the President.

The Trial Judge Advocate returned.

Trial Judge Advocate: The instructions of the Court have been carried into effect.

President: The case will proceed.

LIEUTENANT COLONEL H. A. SKERRY
Witness for the prosecution.

Direct Examination
(Continued)

Assistant Trial Judge Advocate: The witness is reminded that he is still under oath.

Trial Judge Advocate: Where is the place of storage of the secret maps of the 14th Engineers?

A. The very few secret maps of the 14th Engineers are stored with the many more secret maps held under the authority of the Division Engineer in a large, heavy, double-padlocked box in the map section of Regimental Headquarters, Fort William McKinley.

Q. I hand you this map marked for purposes of identification only "Exhibit No. One." What is it? [203]

A. This is a floor plan of the second floor of the

(Testimony of Lieutenant Colonel H. A. Skerry.)
Building No. 332, containing the regimental headquarters of the 14th Engineers. In addition, the drawing indicates the surroundings of the building and roads. The situation on this map is as of October 15th and 16th, 1940.

Q. What can you say as to the accuracy?

A. The map is sufficient for the purpose desired. It is not precise.

Q. How could you tell if a map had been censored?

A. If a map had been censored there would be indicated thereon a statement to the effect that the map had been censored by authority of the party censoring and the undesirable information, secrets, or designs on that map would be deleted, therefrom.

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 3." Has it been censored?

A. This map marked as "Secret", "Exhibit No. 3", has not been censored.

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 4." Has it been censored?

A. This secret map, marked "Exhibit No. 4", "Copy No. 307", has not been censored.

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 5." Has it been censored?

A. This secret map marked "Exhibit No. 5", "Copy No. 322", has not been censored.

(Testimony of Lieutenant Colonel H. A. Skerry.)

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 6." Has it been censored?

A. This secret map, "Exhibit No. 6", "Copy No. 324", has not been censored.

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 7." Has it been censored?

A. The secret map, "Exhibit No. 7", "Copy No. 452", has not been censored.

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 8." Has it been censored?

A. The secret map, "Exhibit No. 8", "Map No. 1023", has not been censored.

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 9." Has it been censored?

A. The secret map, "Exhibit No. 9", "Copy No. 18", has not been censored. [204]

Q. I hand you this map marked, for purposes of identification only, "Exhibit No. 10." Has it been censored? Correction: I hand you this overlay, marked for purposes of identification only "Exhibit No. 10." Has it been censored?

A. The secret overlay, "Exhibit No. 10", further described as "Overlay No. 1, Copy No. 40," has not been censored.

Q. How are all of these maps classified under existing regulations?

(Testimony of Lieutenant Colonel H. A. Skerry.)

A. As "Secret" "Maps and Overlays."

Q. To what, in general, do these maps pertain?

A. All of these secret maps and overlays pertain, in general, to the defense of the Philippine Islands; and, in particular, to the defense in Bataan.

Q. In what way may maps be reproduced? Correction: Name some of the ways in which maps may be reproduced.

A. Maps may be reproduced by the blueprinting process, by the lithography process, by the duplicator process, by the ozalid process, by the black-and-white process, and by numerous other processes not now possessed by the map section of the 14th Engineers. In addition to the above usually used processes, the rather exceptional reproduction by photography should be added thereto.

Q. I hand you these negatives marked, for purposes of identification only: "Exhibits, Numbers 11, 12, 13, 14, 15, 16, 17" and "18." What are they?

A. "Exhibit No. 11" is a photographic negative of a map, showing roads and trails, corrected to February 6, 1939, of an area including the southern tip of Bataan, including the entire Island of Corregidor. There is nothing on this map to indicate the official title of the map from which it was taken, nor is the word, "Secret," indicated thereon.

Member of the Court: Just one minute. A statement was made: "Nothing on this map." I think you meant: "Nothing on this negative."

A. In so far as the negative itself is concerned

(Testimony of Lieutenant Colonel H. A. Skerry.)
the word, "Secret," is not indicated thereon. The witness, however, is unable to state whether the information shown on this negative has been obtained from secret or non-secret sources.

Member of the Court: The original question was asked in an effort to determine if the witness meant "Negative" when he said "Map." The reporter will go back and read the testimony.

Reporter (reading from the record): "Exhibit No. 11" is a photographic negative [205] of a map, showing roads and trails, corrected to February 6, 1939, of an area including the southern tip of Bataan, including the entire Island of Corregidor. There is nothing on this map to indicate the official title of the map from which it was taken, nor is the word, 'Secret,' indicated thereon."

A. The witness meant to refer to the exhibit now in his hand, marked "Exhibit No. 11," as a negative.

Trial Judge Advocate: Please identify the exhibits more briefly.

A. "Exhibit No. 12" is a photographic negative of a secret map. "Exhibit No. 13" is a photographic negative of a secret map. "Exhibit No. 14" is a photographic negative of a secret map. "Exhibit No. 15" is a photographic negative of a secret map. "Exhibit No. 16" is a photographic negative of a secret map. "Exhibit No. 17" is a photographic negative of a secret map. "Exhibit No. 18" is a photographic negative of a secret overlay of a map.

Q. Are these negatives which you have just examined reproductions of maps?

(Testimony of Lieutenant Colonel H. A. Skerry.)

A. Yes, Sir.

Q. Did you at any time authorize anyone to communicate these maps to two civilians?

Defense Counsel: If it please the court, the Defense would like to ask the Court if these maps are to be introduced as evidence.

Trial Judge Advocate: The Judge Advocate does intend to introduce these maps as evidence.

Q. Was anyone authorized by you to communicate these maps or any other secret maps to Mariano Cabrera and Anis Y. Gepte?

A. No, Sir.

Trial Judge Advocate: Subject to objection by the Defense, the Prosecution desires to introduce in evidence the blueprint map marked "Exhibit No. One" and maps marked: "Exhibits Numbers 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, and 18." Exhibits 3 to 18, inclusive, are later to be withdrawn from the record due to their secret contents. Additional copies of the blueprint which is marked "Exhibit No. One" are available for the examination of the Court.

Law Member: Does the Defense Counsel desire to examine any of these maps?

Defense Counsel: The Defense Counsel has examined these maps and has no objection to their introduction. "Exhibit No. One," it understands to be a floor plan [206] of Headquarters, 14th Engineers. The defense has no objection to the introduction of "Exhibit No. One", as identified by

(Testimony of Lieutenant Colonel H. A. Skerry.)
the witness; but reserves the right to object later to the introduction of other "Exhibits No. One" which have not been identified, if such objection appears desirable.

President: The Court desires to know what is meant by "other 'Exhibits No. One.' "

Defense Counsel: I understood the Judge Advocate to say that he had blueprints marked "Exhibit No. One" for distribution to the Court. At present that appears to be of very minor importance. The Defense merely wished to note the right to object later to the introduction of those blueprints as such objection appeared desirable.

President: The exhibits which have been introduced for purposes of identification will be received in evidence as exhibits and as now marked.

Trial Judge Advocate: I have no further questions to ask this witness.

Cross Examination

Defense Counsel: With reference to the testimony relative to censorship of maps, what is the meaning of "Censorship"? What effect does it have with respect to the maps that have been censored?

A. It is possible for the Assistant Chief of Staff, G-2, Philippine Department, to take a map which is marked "Secret" and then to block out the secret information on that map, and then, in his authority, to reissue it as a censored map. In other words, the objectionable material has been removed therefrom.

President: The Court will recess to meet at 2:00 P.M. for members to attend a conference.

(Testimony of Lieutenant Colonel H. A. Skerry.)

The Court then recessed at 11:10 A.M. until 2:10 P. M.; at which time the personnel of the Court; the personnel of the Prosecution; the Defense, less the Associate Counsel, Benjamin C. de Guzman; the Accused, with Major P. R. Taylor as guard; the witness; and the reporter took their seats.

President: The Court will come to order.

Assistant Trial Judge Advocate: The witness is reminded that he is still under oath.

Defense Counsel: The Defense Counsel desires to have the answer defining [207] "Censorship" read again.

Reporter (Reading from the record): "It is possible for the Assistant Chief of Staff, G-2, Philippine Department, to take a map which is marked 'Secret' and then to block out the secret information on that map, and then, in his authority, to reissue it as a consored map. In other words, the objectionable material has been removed therefrom."

Defense Counsel: I understand from that that censorship applies to information that may be added to a map after its original printing, but that the original map itself is never censored. Is that correct?

A. No, Sir. That is not correct.

Member of the Court: What was the answer? I am not sure but I still do not understand censorship.

Witness: I may explain it by a letter sent from the front line by a soldier in combat. He sends it

(Testimony of Lieutenant Colonel H. A. Skerry.)
home to his family. That letter contains certain information which would endanger the national safety. That letter passes to a censor who removes therefrom the objectionable secret information, thereby making the letter of a non-secret nature, permitting its delivery to the young man's parents.

Q. That is just about what I said. The censorship is applied to the map after it is printed?

A. Yes. Or it may be censored on the original tracing and the print may then be safe to issue.

Q. The maps that have been introduced in evidence, you have testified have not been censored. When would such maps ordinarily be submitted for censorship?

A. That particular question is leading too far away from the point in hand. The point I want to bring out is that these are secret maps and are still secret maps. The question that you put is so far away from the case that it will only wind up in confusion.

Q. Is there any reason why these particular maps now in evidence should be censored?

A. No, sir.

Q. In the identification of the exhibits, I believe that their authenticity could be clarified a little. An overlay was introduced into evidence and [208] identified by you as a secret overlay. Can you state whether or not that overlay is secret by competent authority?

A. This same question, Sir, has been previously

(Testimony of Lieutenant Colonel H. A. Skerry.)
taken up with me by the Office of the Department Engineer. It would appear that, in the majority of cases, as evidenced by "Exhibit No. 4," that the map, "Copy No. 307," is made secret by authority of the Commanding General, Philippine Department, and signed by the Assistant Chief of Staff, G-2. In the case of "Exhibit No. 10," the overlay referred to by the Defense Counsel is merely stamped "Secret." It is understood that this included the authority for reproduction by the Department Engineer. The Division Engineer has previously taken this matter up with the Office of the Department Engineer, suggesting that the specific authority for classifying "Secret be specifically placed thereon. There can be no question that the "Exhibit No. 10," the overlay referred to, is a secret map or overlay.

Q. You base that last statement on the fact that at some time someone has placed the word, "Secret," on the overlay. Is that correct?

A. It is correct and also the statement: "ODE, Miscellaneous, 1248, Copy No. 49," which means the "Office of the Department Engineer," who would only permit the word, "Secret," to be on there if such were the case.

Q. Do you understand the information that is portrayed on the overlay? In general?

A. Yes, Sir.

Q. Can you state whether or not that is current or correct information?

(Testimony of Lieutenant Colonel H. A. Skerry.)

A. The information contained in "Exhibit No. 10" is that of a tactical layout of a battle position with the line of resistance and the main line of resistance clearly shown; the date of the overlay being the 29th of January, 1940, may indicate the layout of an old battle position.

Trial Judge Advocate: I object. The present witness is not qualified as being competent to testify whether these are or are not current plans.

Witness: I am not so competent. I am merely trying to answer the question.

Law Member: Objection sustained.

Defense Counsel: I withdraw the question.

President: Put down: "The objection was sustained and the question was withdrawn." [209]

Defense Counsel In identifying these maps you stated: "I believe that the maps pertain to the defense of the Philippine Islands." Did you mean by that that the maps as printed pertain to the defense of the Philippine Islands?

A. No. I meant exactly what I said.

Q. Did you mean that the information added to the map pertained to the defense of the Philippine Islands?

A. I meant by that that the original map, plus the military information placed thereon, together, pertained to the defense of the Philippine Islands.

Q. Now, as to the identification of the photographic negative. In your identification you stated: "This is a photographic negative of a secret map."

(Testimony of Lieutenant Colonel H. A. Skerry.)
Were you making that identification from your recognition of the topographic features displayed in the negative?

A. No, Sir. I was making that identification by finding upon that negative the usual statement by the Commanding General, authenticated by the Assistant Chief of Staff, G-2, that it was a secret map. If there is any question as to the identification of each negative, I can show the Defense Counsel the basis for my statement that it was a negative of a secret map.

Q. In any case would you recognize the terrain in the picture of the photographic negative you recognized?

A. I did not bother with that. I was only concerned with the authority of its being a secret map.

Q. Do you know of your own knowledge that the matter pictured in the photographic negative is actually that which it is represented to be by the printing on the negative?

A. It is a photographic negative.

President: The Court will recess for five minutes.

The Court then, at 2:46 P. M., took a recess until 2:52 P. M., at which time the personnel of the Court; prosecution; the defense, less the associate defense counsel, Benjamin C. de Guzman; the accused, with Major P. R. Taylor as guard; the reporter; and the witness resumed their seats.

President: The Court is called to order.

(Testimony of Lieutenant Colonel H. A. Skerry.)

Q. The Defense understands that the identification of these exhibits is to be [210] a subject of testimony later and consequently withdraws his last question. Colonel Skerry, can you state whether or not any of the maps here in evidence are obsolete or have been declared of no value by the competent authority? A. I do not know.

Q. Are you an expert in photography?

A. No, Sir.

Q. Do you know whether or not any of the maps introduced in evidence have been reported destroyed? A. I do not know.

President: Redirect. Any questions?

Redirect Examination

Trial Judge Advocate: Did you at any time give this accused, Captain Romero, permission to reproduce any of these maps which have been introduced in evidence? A. I did not, Sir.

Q. Did you at any time give the accused, Captain Romero, permission to communicate the contents of these or of any other maps to Anis Y. Gepte and Mariano Cabrera?

A. I did not, Sir.

Trial Judge Advocate: I have no other questions.

President: Recross.

Recross Examination

Defense Counsel: On October 15th or 16th did the Division Engineer have authority to reproduce maps in his safe keeping?

(Testimony of Lieutenant Colonel H. A. Skerry.)

A. The Division Engineer did not have this authority.

Q. Is that true of both dates, October 15th and 16th? A. Yes, Sir.

President: Are there questions from any members of the Court?

Member of the Court: From the numbers on those maps, are they from the file of the Division Engineer?

A. No, Sir. The registered numbers, in accordance with existing regulations [211] are placed thereon by the reproducing agency, in order to keep track of each and every secret map.

Member of the Court: Did those specific maps, with the serial numbers quoted, come from the files of the Division Engineer?

Trial Judge Advocate: I object to the question to this as well as many other questions. They will be brought out by later testimony as the witness on the stand is not the actual custodian of these maps.

Member of the Court: I withdraw my question.

Law Member: Were Mariano Cabrera and Anis Y. Gepte entitled to receive the information contained in these maps and overlays on or about October 15, 1940? A. They were not, Sir.

Member of the Court: If you are, by competent authority, directed to make an overlay of a secret map, is that overlay secret? A. It is.

Trial Judge Advocate: The Prosecution has no further questions, but desires authority to withdraw the maps under discussion from the record because of their secret nature, at the conclusion of this trial.

Defense Counsel: No objection from the Defense.

Law Member: Since there is no objection they may be withdrawn at the close of the trial.

President: The Court will take a recess.

The Court then took a recess at 3:06 P. M. until 3:12 P. M.; when the personnel of the Court; the personnel of the prosecution; the defense counsel, the assistant defense counsel, the associate defense counsel; the accused, with Major P. R. Taylor as guard; the witness; and the reporter, Katherine Mason, took their seats. [212]

ANIS Y. GEPTE

Witness for the prosecution:

Q. Where did you go?

A. I went to the office of Mr. Agbay and we are supposed to meet Mr. Cabrera in the office. I met Mr. Agbay and Mr. Cabrera.

Q. You stated that you had asked them to show you maps and they said they would show you some maps at any time.

A. I told Mr. Cabrera that the Sultan told me that if they are really on the business, they should show him any maps. At this time, Mr. Agbay told

(Testimony of Anis Y. Gepte.)

me that we should go over to Tolentino Street that afternoon. When we arrive in the house of Mr. Agbay, he called up Mr. Cabrera. Mr. Cabrera then showed me a map, a blueprint marked "Restricted."

Q. What did you do then? What did you say?

A. I told him if he would allow me to take this map to the Sultan, in order to show him. At first we had discussed and after that agreed that I can take the map on condition that I must return it on the next day.

Q. What map did he give you at that time?

A. It was the Lingayan Gulf.

President: If reference is made to any particular maps, is it necessary for the remainder of the nonmilitary personnel to leave?

Prosecution: Sir, I don't believe so at this time.

Questions by Prosecution Continued:

Q. I hand you this map, marked for identification purposes only, Exhibit 2. (Handing map, Exhibit 2, to witness) What is it?

Associate Counsel: I object to that question, because the document speaks for itself. [218]

Law Member: Objection overruled.

Witness: (Examining Exhibit 2) It looks like the map that was given to me by Mr. Cabrera, of the Lingayan Gulf. It is marked "Restricted."

[219]

(Testimony of Anis Y. Gepte.)

Fort William McKinley, P. I.

November 13, 1940.

The court was called to order at 8:30 A.M., November 13, 1940.

All the personnel of the court, prosecution, and defense who were present at the close of the previous session in this case being present.

The accused, his guard and the reporter were also present.

President: Reporter will be sworn in.

Sergeant George G. Barry, 6575382, Div. Hq. Det., C. W. Section, Headquarters and Military Police Company (PS) was duly sworn in as the court reporter in this case.

Direct Examination

(Continued)

Assistant Trial Judge Advocate: Witness is reminded that he is still under oath.

President: Court will be cleared and closed.

The court was closed at 8:35 A.M. and was reopened at 8:40 A.M.

Trial Judge Advocate: (To witness) You are reminded you are still under oath.

Defense Counsel: If it please the court the accused at this time requests that the court excuse the Assistant Defense Counsel, Captain Ivy, during the remainder of this case.

President: The court desires a reason for that request.

Defense Counsel: The accused feels a certain

(Testimony of Anis Y. Gepte.)

amount of antipathy against the Assistant Defense Counsel and feels that the Assistant Defense Counsel has a certain amount of antipathy toward the accused.

President: The accused does not request the presence and further services of the Assistant Defense Counsel?

Defense Counsel: That is the accused's opinion.

President: Is it his request that he be excused?

Defense Counsel: Yes sir.

President: Subject to objection to any member, the Assistant Defense Counsel is excused. Does the accused request any other officer to assist in his defense?

Defense Counsel: The accused does not.

President: There being no objection Captain Ivy is excused and will withdraw from the court.

[224]

President: The court will come to order. The court takes notice of the fact that the Associate Defense Counsel Benjamin C. de Guzman has withdrawn from the case. The case will continue. [247]

Cross Examination

Defense Counsel: And it was at your instigation that maps finally were shown to you at Fort McKinley on October 15, 1940?

A. It was Major Evans, G-2 of the United States Army.

Defense Counsel: You were acting as an agent for Major Evans in this case?

(Testimony of Anis Y. Gepte.)

to be under the G-2 of the United States in this case. [266]

MAJOR J. K. EVANS

witness for the prosecution:

I made all arrangements for search warrants and raiding parties in connection with the residence of the accused and the residence of the co-accused, Cabrera.

Questions by Prosecution Continued:

Q. With whom?

A. The arrangements were made with the Chief of the Information Division of the Constabulary, who detailed his assistant, Captain Gabriel, to work with me. When I was informed that all was in readiness and that the reproductions were in the process of being made, the raiding party started out and raided the two places simultaneously. After surrounding the house at 100 Calle Del Pan, the residence of the accused, I entered the front door, which was merely a screen door and was not fastened shut, and had proceeded about half way across the sala without seeing anyone, when the door to a bedroom in the back of the house opened and the co-accused, Cabrera, looked out. When he saw me, he ducked back in the door and closed the door. I ran the remaining distance and kicked the door open before it had fully closed, and found the accused, the co-accused, Cabrera, and the wife of the accused in

(Testimony of Major J. K. Evans.)

the room, and an individual whom I didn't identify at the time, had just ducked out a side door. The accused, his wife and Cabrera had started after him, but I stopped them and required them to go to the opposite side of the room. There was a wire coat hanger hanging on a light fixture in the middle of the room and to it were attached several photographic negatives, apparently drying, [273] for when I touched one it was still damp. At another place in the room there were still more negatives. I found a total of eight photographic negatives, all of them reproductions of secret maps of the United States Army pertaining to the national defense. In the room also were found several rolls of documents, which proved to be classified maps and overlays. In the basement of the house was a dark room which gave every evidence of having been recently used. A light was still burning inside the room and the equipment was in such disarrangement as to indicate recent use. Obtaining the keys to the accused's automobile, I opened the trunk of the car and found another large roll of classified documents belonging to the United States Army. The accused was taken into custody, and, at his request, was permitted to leave the house and enter my automobile so as to save him the embarrassment of being seen in that status by his children upon their return. The accused showed some signs of agitation, but took the whole thing more calmly, apparently, than did his wife, who seemed to be on the verge of

(Testimony of Major J. K. Evans.)

hysterics. I took possession of all the classified documents found, so as to prevent them being seen by other members of the raiding party which, by the way, included a Sergeant of the Military Police, United States Army, also, and I took the documents, the photographic negatives and the accused to Fort McKinley. [274]

Cross Examination

(Continued)

Q. The Defense withdraws the last sentence. Why did you give Gepte a list of maps that you desired him to obtain?

A. I am unaware of having testified of having given him a list of maps.

Q. The witness Gepte has testified among other things that you told him to obtain the plan of the defense of Bataan or the Philippines, I cannot recall which.

A. I myself testified that I told him what to ask, that is not giving him a list. I make no list and gave him no list. During direct examination because the court was in open session I did not state in detail what I indicated that Gepte should ask for. I actually indicated that he should request maps in general showing dispositions on Corregidor and Bataan, the entrance to Manila Bay and the Department War Plan. He reported to me that he could obtain without delay everything except the war plan which he had been told might take a

(Testimony of Major J. K. Evans.)

month or two but could be obtained. My reason for indicating to him what to ask for was to test the information which I then had to the effect that the accused was prepared to furnish such things for a price. [285]

Examination by the Court

President: During your testimony you referred to the negative as a negative found by you in the raid. In what raid?

A. The raid by a Constabulary party, armed with a search warrant which took place at No. 100 Calle Del Pan at about 4:30 P.M. on October 16, 1940 and which I accompanied.

President: Who was the resident—what individual resided at that address?

A. That was the residence of the accused.

President: You testified that you obtained these negatives at the time of the raid and turned them over to Lt. Col. Seeley, were they continuously in your possession from the time you obtained them until you delivered them to Lt. Col. Seeley?

A. They were.

Defense Counsel: The search warrant that you had for the raid, authorized you to enter and search said premises, is that correct?

A. I had no search warrant for the raid. I did not make the raid.

Defense Counsel: Did you see the search warrant that the party had or some individual of the raiding party had?

(Testimony of Major J. K. Evans.)

A. Captain Gabriel of the Constabulary had the warrant in his possession and I heard him offer to read it to the accused which action the accused refused. I never had the warrant in my hands. [290]

CAPTAIN AUGUSTINE G. GABRIEL

witness for the prosecution.

Direct Examination

Questions by Prosecution:

Q. Please state your name, occupation and residence.

A. Augustine G. Gabriel, Captain, Philippine Constabulary, residing in Manila, Philippine Islands.

Q. Do you know the accused?

A. Yes, sir, I do.

Q. State who he is.

A. He is Captain Rufo C. Romero of the United States Army.

Q. How did the accused come to your attention on or about October 15th, 1940?

A. In the afternoon of October 15th, 1940, I accompanied Major Evans of the United States Army, with a couple of agents from our office, and proceeded to the residence of Captain Romero, located at Del Pan [293] Street, Pasay, Rizal. I was carrying with me a search warrant issued by the court. My mission was to assist Major Evans in his work of locating some maps—secret maps of the

(Testimony of Captain Augustine G. Gabriel.)

United States Army allegedly kept in the house of Captain Romero. When we arrived at the house of Captain Romero, we found one of the rooms closed and locked. Major Evans knocked at the door. The door was not opened immediately, and later I saw Major Evans force the door open. When the door opened, we saw Captain Romero and a Filipino inside the room. This room, it was later pointed out to us that it was the bedroom of Captain Romero. We saw Captain Romero and the Filipino civilian standing in the room. In the search we made, in the bedroom we found some photographic negatives hanging. Also, we found two rolls of maps. One, I remember, was marked, "Restricted," and the other roll, according to Major Evans, was a secret military map. The other map was a blue print map folded.—

Defense Counsel: May it please the court, the defense, at this time, objects to the admissibility of this evidence until it is proven that the search was legally conducted. It is true the witness has testified that he had in his possession a search warrant, but so far, there is nothing to show that the warrant was legally issued, nor that it directed a search of the house of Captain Romero, nor for what purpose the warrant was issued. These facts, I believe, should be proven before the testimony is admitted.

Law Member: Is there anything from the prosecution?

Prosecution: The witness is a Police Officer under whose direction the search warrant was legally

(Testimony of Captain Augustine G. Gabriel.)
procured, and I cannot see the basis of his objection on the ground of lack of legality of the act. [294]

Law Member: Was the house which was searched on any military reservation?

Witness: I know for sure that the house referred to is outside of the military reservation.

Law Member: The objection is sustained and the evidence with regard to the search will not be considered at this time.

Questions by Prosecution Continued

Q. Where is the search warrant which was procured at this time?

A. The search warrant was returned to the court—the Justice of the Peace Court of Pasay, who issued it.

Q. Who actually procured the search warrant?

A. Two agents from our office, under my direction, procured the search warrant.

Q. What are their names—the names of the officers who procured the search warrant?

A. Just now I can't recall the two agents who went to court to procure the warrant, but I have an officer here with me now, named Lieutenant Villafria, who prepared the application for the search warrant and examined the legality of the application and made certain it conformed to the requirements of the law, he being a lawyer.

Q. Did you have the search warrant with you at the time you entered Captain Romero's quarters?

A. Yes, sir, I did, and I made announcement to

(Testimony of Captain Augustine G. Gabriel.)

Captain Romero and Mrs. Romero that I had a search warrant with me and I told them that it is my duty to inform them and, if necessary, to read the contents of the warrant to them, and both of them told me there was no necessity for me to read the warrant and they allowed me to conduct the search in the house. [295]

Law Member: Was the search warrant issued and returned to any court or other tribunal having authority to issue it?

Witness: As I said, sir, the warrant was applied for in the Justice of the Peace Court in Pasay, and the Judge believed he had the right to issue the search warrant.

Law Member: Was that warrant returned to the Justice of the Peace for his records?

Witness: Yes, sir.

Prosecution: If the court desires, we can produce in court the officer who issued the warrant, to testify further concerning the legality of this act.

President: Can the warrant be obtained?

Prosecution: If necessary, I believe the warrant can be obtained. There would be a slight delay in order to send down to Pasay and get it. (To witness) It is in Pasay?

Witness: Yes, sir.

Law Member: That warrant would speak for itself and not require anyone to testify to it.

Prosecution: May we have a five-minute recess?

President: The court will take a five-minute recess.

(Testimony of Captain Augustine G. Gabriel.)

The court then, at 8:40 o'clock, A. M. took a recess until 8:47 o'clock, A. M., at which time the personnel of the court, the prosecution and the defense, and the accused, the reporter and the witness resumed their seats. [296]

President: The Judge Advocate will obtain the search warrant. The court will recess, and meet at 10:00 o'clock. The court is recessed.

(The court then, at 8:50 o'clock, A. M., took a recess until 10:27 o'clock, A. M., at which time the personnel of the court, the prosecution and the defense, and the accused, the reporter and the witness resumed their seats.)

The witness was reminded that he was still under oath.

Prosecution: May it please the court, the prosecution and the defense have agreed to stipulate concerning the facts in connection with the procurement and service of the search warrant on the premises of the accused, and I offer, subject to confirmation of the accused and his counsel, a statement as to the stipulation: The prosecution and the defense join in stipulating that the search warrant authorizing the search of the premises and person of the accused, at 100 Del Pan Street, Pasay, Rizal, Philippine Islands, on October 16th, 1940, was issued and executed by competent authority under the laws of the Philippine Commonwealth. This stipulation is being made to permit the continuance of the trial at this time, and with the

(Testimony of Captain Augustine G. Gabriel.)
understanding that the original of the search warrant will be produced in court at a later time

Defense Counsel: The defense agrees to that stipulation.

Law Member: Does the accused understand what is involved in this stipulation?

Accused: I guess I do.

Law Member (To Accused): Do you understand it? [297]

Accused: I never saw it, sir. I just read it now. I think I understand it.

Law Member (To Accused): Do you want it read from the record by the reporter?

Accused: Not necessarily, sir.

Law Member (To Accused): You understand what was stipulated?

Accused: I think I do, sir.

Law Member: Subject to objection by any member of the court, the stipulation will be received as stated.

Prosecution: Will the reporter please read Captain Gabriel's last statement?

(Reporter then read from the record, Line 23, Page 293, through the end of the first paragraph on Page 294.)

Prosecution: The prosecution noted that the question originally asked Captain Gabriel, was, "How did the accused come to your attention on October 15th, 1940?" That date should read "October 16th, 1940."

(Testimony of Captain Augustine G. Gabriel.)

Defense Counsel: For the clarification of the record, the defense believes that the reply of the witness should also relate to the corrected date.

President: It will stand corrected.

Questions by Prosecution Continued:

Q. What was the date on which you executed the raid on the premises of the accused, Captain Romero?

A. It was on October 16th, 1940. [298]

Q. Will you please go ahead with your statement as to what further happened on those premises?

A. Adding to my testimony, with reference to the blue print folded map I saw that it is marked—it bears the mark “For Official Use Only.” Major Evans and I later left the bedroom while some of my agents remained in the room with instructions to continue making the search. Major Evans and I went to the basement of the house and there we found a dark room. We made an examination of the dark room and Major Evans pointed out to me that there were indications that very recently someone had been there, and I agreed to his opinion, because I saw some of the pans still wet. We made a search in the dark room and we found no maps. Later, we left the dark room and we saw the car of Captain Romero parked under the house in the basement. We searched the car and we later found out that the trunk of the car was locked, and we asked for the key and Mrs. Romero handed to us the key. We searched the trunk of

(Testimony of Captain Augustine G. Gabriel.)

the car and we found two rolls of maps, and according to Major Evans, those were secret maps belonging to the United States Army. After leaving the basement, we proceeded again to the house and searched the other rooms, and we also found nothing in the other places of the house. We came back again to the bedroom and I was informed by the agents who were instructed to make the search, that they found some materials which they thought were useful for photographic purposes. During our stay in the house, we also found another civilian, who was about to leave the house by taking the rear stairway, and he was placed under arrest.

Q. Who was this civilian?

A. This civilian was later identified to be Ignacio Agbay, and referring to the other civilian found in the room of Captain Romero, he was identified to be Cabrera. Immediately after Major Evans discovered [299] that we found the articles we were searching for, he made an announcement that Captain Romero and Cabrera, who was found with him, in the room—that they were under arrest. After that, I directed one of my agents to make a list of all of the articles found in the dark room in the basement of the house, and also an inventory list of the articles found in the bedroom. After the preparation of this list, Major Evans took all of the maps and photographic negatives and informed me he was going to take care of them

(Testimony of Captain Augustine G. Gabriel.)
and take them to the proper military authorities, and after taking Captain Romero, who was under arrest, he left us in the house of Captain Romero, and Major Evans told us he was proceeding to Fort McKinley.

Q. What persons did you instruct to make the list of materials, to which you have referred?

A. I instructed Agent Flores to prepare the list of the articles found in the bedroom, and Agent Alfonso to prepare the list of the articles found in the dark room.

Prosecution: No further questions.

Cross-Examination

Questions by Defense Counsel:

Q. Captain Gabriel, who composed the party that conducted the raid to which you have just referred?

A. We were two officers—Major Evans and myself—and the rest are agents of the Constabulary and an American operative who came along with Major Evans.

Q. Who was in charge of the raiding party?

A. I should say that both of us, Major Evans and I, were in charge of the raiding party. [300]

Q. Are you an officer of the law?

A. Yes, sir. I am vested with the authority as a Police Officer.

Q. Is Major Evans vested with that authority?

A. I am not very sure of myself, but my impression is that he is not vested with police powers like myself. [301]

FIRST LIEUTENANT MYRON E. PAGE

witness for prosecution.

On October 15th, Captain Romero returned from leave and became the Topographical and Intelligence Officer, in which capacity I had been acting in his absence. [346]

MASTER SERGEANT GRACIANO DELDA

witness for prosecution.

Q. Do you know in what sort of paper Sergeant Dangoy wrapped the bundle of maps?

A. I cannot say exactly sir because in our office there are various kinds of wrapping paper some are Manila, the ordinary Manila wrapping paper and some are waste blue print paper.

Q. Do you use old copies of maps, blue prints?

A. Sometimes we do sir, after examining the importance of any paper that we consider waste.

Q. Have you used—do you use maps that are marked restricted for sketching paper on the back and wrapping paper?

A. I believe we have done that sir.

Q. Do you have any maps in the office that are not United States Government maps? That are the personal property of some individuals?

A. Yes sir we have various maps in the office published by the Philippine Government and I do not know if there are any maps that are the personal property of anyone. [365]

(Testimony of Master Sergeant Graciano Delda.)

Examination by the Court

Q. How do you know what maps to select?

A. In the first place I had a record of maps to be returned in addition to the record I suggested to Captain Romero that we had a bunch of secret maps that were out of date and they might as well be returned since they were obsolete.

Q. Who gave you the record to which you just referred?
A. Lieutenant Page. [368]

Recross Examination

Questions by the Defense Counsel:

Q. Can you name or identify the secret maps that were out of date and should be returned?

A. If I see them sir and if I can check them against our records, check the numbers against our records I can identify those maps.

Q. Can you state in general what areas there—what areas were covered by these secret maps which were obsolete?

A. Yes sir, they covered the vicinity of Mari-veles and Fort Mills.

Q. Any more of Bataan and the vicinity of Mari-veles?

A. I do not remember sir.

Q. Did the maps to which you refer have on them any military information shown by conventional signs?

A. Yes sir, they were topographic maps of a

(Testimony of Master Sergeant Graciano Delda.)
large scale and showed the terrain, roads and
some maps showed disposition of troops, some
maps—— [369]

CAPTAIN AUGUSTIN G. GABRIEL

witness for prosecution.

Direct Examination

Questions by the Prosecution:

Q. Captain Gabriel in your previous testimony you made reference to a search warrant which was procured under your direction giving authority for a search of the premises and person of the accused, do you have that search warrant with you at this time?

A. Yes, sir, I do have it here with me.

Q. By whom was—I will change that. Was that search warrant issued by proper authority under the laws of the Philippine Commonwealth?

A. Yes sir, I am of the belief that the search warrant was issued by competent authority and issued in the proper and legal way.

Q. Will you please read the warrant for the information of the court?

Law Member: May I suggest that the Counsel be given the opportunity to examine the warrant. (Defense Counsel examines the warrant.)

Trial Judge Advocate: Will the Defense Counsel dispense with the reading of the search warrant. [371]

(Testimony of Augustin G. Gabriel.)

Defense Counsel: Yes sir.

Trial Judge Advocate: Does any member of the court desire to have the search warrant read into the record?

President: Is this search warrant to be introduced as a document in evidence before the court.

Trial Judge Advocate: The search warrant was produced in this court on the request of the court.

Law Member: Is it to remain in evidence?

President: The question was, is that copy of this search warrant to remain in evidence as part of this record?

Trial Judge Advocate: It cannot remain in evidence as an exhibit as it is a part of the permanent records of the issuing court.

Law Member: It being an official record of a court, it may be introduced if so desired with permission to withdraw it or return to its proper source and a true copy be furnished for the records.

Member of the Court: May it please the court that search warrant be read into record by the witness.

President: Any objection from any member of the court? (No response.) The search warrant will be read into evidence by the witness.

A. (Witness reads) "United States of America, Commonwealth of the Philippines. In the Justice of the Peace, Court of Pasay, Province of Rizal. The People of the Philippines versus Capt. Rufo Romero 100 Del Pan Street, Pasay, Rizal. Search

(Testimony of Augustin G. Gabriel.)

Warrant No. 121. To any Officer of the Law: Whereas on this day proof, by affidavit, having been presented before me by Agents Ceasar E. Santos and Santiago L. Safe of the Information Division, Philippine Constabulary, that according to confidential investigation and observation there is probable cause to believe that in the house of Captain Rufo Romero at 100 Del Pan Street, Pasay, Rizal, there are being kept stolen maps belonging to the United States Army. Therefore, you are hereby commanded during any time of day and night to make an immediate search on the person of Captain Rufo Romero and other persons that may be found thereat or in the premises of the above given address for the following property: 'Stolen Maps Belonging to United States Army' and, if you find the same or any part thereof, to bring it forthwith before me in the Justice of the Peace Court [372] of Pasay, Rizal. Witness my hand this 15th day of October, 1940, at Pasay, Rizal." Signature illegible but I know who signed it. "Justice of the Peace, Pasay, Rizal."

President: The court desires that this document be introduced as evidence, the original to be returned to the court from which it was issued. Any other question?

Trial Judge Advocate: No, sir. Has the document been received in evidence?

President: The document will be received in evidence unless there is an objection by the accused.

(Testimony of Augustin G. Gabriel.)

Law Member: The document should also be received as Exhibit No. 20 with permission to withdraw the original and to substitute a true copy though for the record.

Trial Judge Advocate: The Prosecution has no further questions. [373]

MAJOR NARCISO L. MANGANO

Witness for the prosecution.

Q. Why did you open the safe for the accused?

A. Because the accused was reporting back for duty as intelligence officer and topographical officer and taking over the duties temporarily held by Lieutenant Page. [386]

IGNACIO AGBAY

Witness for the Defense.

Counsel for the witness was admitted with the understanding that he could advise the witness whether or not to answer a question, and he is not to consult with anyone else. He will take his seat and comply with the instructions of the court. [431]

Q. Did you come to any agreement with Gepte at the London Restaurant? A. Yes, sir.

Q. What was that agreement?

(Witness looks at his lawyer, who nods his head) [446]

(Testimony of Ignacio Agbay.)

A. The agreement was that I am going to help him if I—(To Reporter) Will you read what I said?

(Reporter read from the record, as requested.)

A. —will work with him under his instruction.

Q. Did you receive any offer of reward or pay?

A. Yes, sir.

Q. What was offered you?

A. Cash was the offer, and promise of a position as secret service or agent of the Philippine Constabulary, in case we will be successful on the case that he is after. (To Reporter) Please repeat that again.

(Reporter read from the record, as requested, last answer of witness)

Q. What case was that?

A. The case—the frame-up case that he proposes to me.

Q. And who was the party to be framed?

A. Captain Romero. [447]

(Reporter read from the record, as requested, and Interpreter translated same to the witness)

(Mr. De Guzman, lawyer for the witness, spoke to the witness.)

Prosecution: The witness did not ask for advice of counsel.

President: (To Reporter) Enter in the record that lawyer cautioned the witness. [451]

President: Counsel has already been cautioned three times. He will now move his chair behind that table. (Indicating table about ten feet to the right rear of the witness)

(Mr. De Guzman, lawyer for the witness, then took his position as indicated by the President) [455]

Law Member: Now, let me add: The witness may, if he desires, ask his lawyer for advice. That is the purpose of having his lawyer here.

(Witness turns and looks at Mr. De Guzman, his lawyer, who shakes his head.) [457]

Witness: (To his lawyer) Can I answer that.

(Mr. De Guzman, lawyer for the witness, shook his head)

Witness: I cannot answer that question. [460]

Witness: (To his lawyer) Can I answer that?

(Mr. De Guzman, lawyer for the witness, nods his head.) [461]

Witness: (To his lawyer) Shall I answer that?

(Mr. De Guzman, lawyer for the witness, nods his head.) [463]

Witness: (To his lawyer) Can I answer?

(Mr. De Guzman, lawyer for the witness, shakes his head)

Witness: I don't want to answer, sir. [467]

President: The court notes the lawyer is absent.

(Interpreter and witness converse in Tagalog)

Witness: (Through Interpreter) I am going to stand without my lawyer. [472]

(Benjamin C. De Guzman, lawyer for the witness, entered the courtroom.)

(Fiscal Dinglasan entered the courtroom and remained as a spectator)

MARIANO CABRERA,

Pazay, Rizal, a witness for the defense, was sworn and testified as follows:

Defense Counsel: May it please the court, the attorney for the witness on the stand, is present in court and requests permission to sit in the same capacity as he did for his other client, this last witness, Agbay.

President: The attorney for the witness may sit at the table and the witness may use the attorney as an adviser as to whether or not the witness shall answer the questions. This means there will be no consultation during testimony. The trial will proceed.

(Benjamin C. De Guzman, lawyer for the witness, took his position at a table to the right rear of the witness)

(Testimony of Mariano Cabrera.)

Questions by Assistant Trial Judge Advocate

Q. State your name, occupation and residence, please.

A. Mariano Cabrera, twenty-four age, movie actor and painter.

Q. Where is your residence?

A. Pasay, Rizal.

Q. Do you know the accused? A. Yes, sir.

Q. What is his name? A. Captain Romero.

Assistant Trial Judge Advocate: Defense witness. [497]

A. Excuse me, sir. Can I ask my counsel whether I will answer the question, sir?

(Witness looks at Mr. Benjamin C. De Guzman, his lawyer, who nods his head)

Witness: Yes, sir. [516]

Q. What were you going to do at that house?

(Witness turns and consults with his lawyer, Mr. Benjamin C. De Guzman, who stated he did not hear the question and asked to have it read. The Reporter read the question from the record and Mr. De Guzman nodded his head, after which the witness answered as follows:)

A. Well, we just went there, and I don't know what's to be done. * * * [522]

Q. What was the proposition?

A. After Mr. Agbay stepped out, sir, Mr. Gepte told me, he says, "I am a 'D. I.' and you know Captain Romero is on the spot, and I promised my superiors that I will be investigating Captain

(Testimony of Mariano Cabrera.)

Romero," and after that, he told me, "I want to ask help from you." I said, "What kind of help could I do?" Upon knowing that I made a quarrel with Captain Romero about three or four days before that, Datu Ding has proposed and offered me that he will give me five hundred pesos and promised me, as I am very interested, to be a special agent, as I have had already recommendations for a long time. He promised me [524] that, "If you can help me and if we succeed, I could recommend you to Colonel Segundo, to be a 'D. I.' or a special agent, and I will give you the five hundred pesos that I promised." That is the proposition, sir.

Q. Knowing all of those things, you still state that you do not know why the group came in the car on the night of October 15th, to Fort McKinley. Is that correct?

A. Yes, sir, because Mr. Gepte instructed me, after having the proposition with him, just to follow every instruction he will order me, sir, and he say, "If I will be in Captain Romero's house, please stay aside and let me talk with him alone, if possible," so they are talking, sir, and I was away, over by the window by the son of Mr. Gepte.

Q. Were you, Agbay and Gepte laying a trap for Captain Romero?

A. I beg your pardon, sir?

Q. Were you, Agbay and Gepte laying a trap for Captain Romero?

A. That is what was supposed to be, sir.

(Testimony of Mariano Cabrera.)

Q. Why?

A. Because, according to Mr. Gepte, after having what he wants, he will have a premium from the Government, and he promised to give me five hundred pesos and he promised very much that he will recommend me to Colonel Segundo for me to be a special agent. That is the trap he laid out.

Q. Why should a trap be laid for Captain Romero? Did you believe he was about to do something wrong?

A. No, sir, but Mr. Gepte told me that Captain Romero was on the spot.

Q. Why?

A. I don't know, sir. He say that he was investigating Captain Romero because of the gambling. [525]

Defense Counsel: May it please the court, the defense has no more witnesses to offer and the defense rests.

Law Member: Captain Romero, you have the legal right now, to do any one of several things, just as you choose. First, if you want to do so, you may be sworn as a witness and testify, under oath, in this case, like any other witness; or second, if you do not want to be sworn as a witness, you may, without being sworn, say anything about the case to the court, which you desire, that is, make what is called an unsworn statement; or you may,

if you wish, file a written statement with the court; or third, you may, if you wish, keep silent and say nothing at all. I will explain these rights to you in order: First, if you desire to be sworn as a witness and testify in your own behalf, you may do so, but you are not required to do so and you cannot be sworn unless you ask it. If you are sworn as a witness in your own behalf, that means that you take the stand like any other witness and promise, under oath, that you will tell the truth, the whole truth and nothing but the truth about this case. If you do that, whatever you say will be considered and weighed as evidence by the court, just like the testimony of any other witness. That is, the Trial Judge Advocate and any member of the court can question you to find out whether or not you are telling the truth and what weight should be given to your testimony, and questions will not be confined to just that part of your denial or explanation which you may give while testifying yourself under the guidance of your counsel, but they can question you about the whole subject of the offense charged against you, and may also ask you questions to test your worthiness of belief, but if your testimony should only be in denial or [551] explanation of just one or two of the offenses charged against you, and not about the others, and you should not say anything about the others, then they can question you about the whole subject of those offenses concerning which you testify, but they cannot question you about the offenses con-

cerning which you did not testify. If you do take the witness stand and fail to deny or satisfactorily explain any of the alleged wrongful acts about which you testify at all, and about which any evidence has been presented, such failure on your part may be commented on to the court by the Trial Judge Advocate when he presents his argument to the court at the end of the trial, and the court can take it into consideration in determining whether you are guilty or innocent of the offenses. Do you understand fully all that I have said to you so far?

Accused: Yes, sir.

Law Member: Second: Your second choice is that if you do not want to testify under oath, you may, without being sworn, say anything you desire, to the court, as an unsworn statement denying, explaining or excusing any of the acts charged against you here. You can do this yourself, or you can have your counsel do it for you, or you can do both; that is, you may say anything you desire yourself in this way, and have your counsel add anything else for you that you want him to. In making such a statement, you are not a witness and do not have to take an oath, and cannot be questioned or cross-examined by anyone. If you wish, you can file your statement, in writing, or have your counsel file a written statement for you, or you may both make an oral statement and also file a written statement, if you want to do so. In such statement, you can refer to the evidence produced against you [552] here, and you can explain

your motive in doing anything you may have done, or you can deny or contradict any testimony given or offer any excuse or explanation you may see fit, and you may also, if you wish, discuss the legal principles applying to your case, and make an argument to the court both upon the facts of the case and upon the law. Since such a statement is not given under oath and you cannot be cross-examined upon it, it cannot be given the same weight with the court as sworn testimony under oath, but it will be considered by the court and given such weight as it may seem to deserve. Furthermore, even though you may be sworn as a witness, you may also, if you wish, afterwards make a statement of this kind, not under oath, either verbally or in writing. Do you understand clearly all that I have said thus far?

Accused: Yes, sir.

Law Member: Third: Your third choice, if you do not want to testify as a witness in your own behalf, and do not desire to make an unsworn statement, either orally or in writing, is, if you so wish, to remain silent—to say nothing at all. You have a perfect right to do this if you wish, and if you do so, the fact that you stand on your legal rights and do not take the stand yourself, or make any statement, will not count against you in any way, with the court. It will not be considered by the court as any admission that you are guilty, nor can it be commented on in any way, by the Trial Judge Advocate in addressing the court. It is your

legal right to remain silent, if you wish to do so. Do you now understand all I have said?

Accused: Yes, sir. [553]

Law Member: You understand now, your right to do any one of these things, as I have explained them to you; that is, first, to testify as a witness, if you wish; second, to make an unsworn statement, either verbally or written, if you wish, or both, either without having been sworn or in addition to your testimony if you shall be sworn; and third, your right to remain silent and say nothing at all. Knowing these various rights, take time to consult with your counsel and then state to the court which you wish to do.

Accused: I will take the second choice; that is, make an unsworn statement, sir. The statement I will make does not include any secrets except those that I have reported to G-2, and if you do not want me to mention the star witness of the prosecution, I won't mention his name, but I will call him "Mr. X." I won't mention any name, but I will——

President: (To Accused) The court does not desire to hamper you in any way in making your statement. If you wish to make part of your statement with the spectators present, you may do so, and if you wish to make the other part of it with the spectators excluded, you will tell the court and we will then exclude the spectators.

Accused: I do not want to mention the name of the star witness on the other side. It has been the policy here not to mention him. I will call him

“Mr. X,” and then we can insert later on in the record that it was him whom I meant, and when I come to the secret part, I will warn the President, so we can exclude the spectators.

Law Member: Subject to objection by any member, the accused may proceed as he has requested.

[554]

Accused: Major Evans testified that he himself opened the trunk of my car and got the maps now in evidence. I believe, therefore, that these maps should be rejected as evidence, because Major Evans has no authority to execute a search warrant issued by the civil courts of the Philippine Islands. [555]

Neither the prosecution nor the defense having anything further to offer, the court was cleared and closed, and upon secret written ballot, three-fourths of the members present at the time the vote was taken concurring in each finding of guilty, finds the accused: [635]

Of Specification 1: “Guilty”

Of Specification 2: “Guilty”

Of Specification 3: “Guilty”

Of Specification 4: “Guilty”

Of the Charge: “Guilty”

The court was opened and the Assistant Trial Judge Advocate stated, in the presence of the accused and his counsel, that he had no evidence of previous convictions to submit.

The Assistant Trial Judge Advocate read the data as to age, pay and service, as shown on the Charge Sheet, as follows:

“Name of the accused: Romero, Rufo C., O 18350,

Captain, Philippine Scouts (CE), 14th Engineers (PS), Fort William McKinley, P. I.

“Age 32. Pay, \$230 per month. Allotments to dependents, None per month. Government Insurance deduction, \$17.35 per month.

“Data as to service: Cadet M. A., July 1, 1927 to June 10, 1931; 2nd Lt. P. S. June 11, 1931 to July 31, 1935; 1st Lt. Aug. 1, 1935, appointed Captain Sept. 9, 1940, accepted October 4, 1940.

“Data as to restraint of accused: Confined since October 16, 1940 at Fort William McKinley, P. I.”

President: (To Accused) Is the data as to service correct?

Accused: Yes, sir. I think so.

Neither the prosecution nor the defense having anything further to offer, the court was cleared and closed, and upon secret written [636] ballot, three-fourths of the members present at the time the vote was taken concurring, sentences the accused:

“To be dismissed the service, to forfeit all pay and allowances due or to become due, and to be confined at hard labor, at such place as the reviewing authority may direct, for fifteen (15) years.”

The court was opened and the president announced the findings and sentence.

The court then, at 4:07 o'clock, P. M., on No-

vember 25, 1940, adjourned to meet at the call of the president.

CLIFFORD BLUEMEL,

Colonel, 45th Infantry (PS),
President.

LEWIS C. BEEBE,

Lieutenant Colonel, 57th Infantry (PS),
Trial Judge Advocate. [637]

HEADQUARTERS PHILLIPINE DIVISION
Fort William McKinley, P. I.

January 14, 1941.

In the foregoing case of Captain Rufo C. Romero, O18350, Philippine Scouts (CE), 14th Engineers (PS), the sentence is approved and the record of trial is forwarded for action under the 48th Article of War.

J. M. WAINWRIGHT,

Major General, U. S. Army,
Commanding.

RECOMMENDATION

HEADQUARTERS PHILLIPINE DIVISION
Fort William McKinley, P. I.

January 14, 1941.

In view of the announced policy of the War Department to separate general prisoners convicted of offenses punishable by penitentiary confinement from general prisoners convicted of purely military offenses, or of misdemeanors (par. 90a, M.C.M.),

and in view of the peculiar knowledge of the accused of the national defense plans and of the topography of Luzon, with the attendant opportunity, due to lack of facilities for proper supervision, of transmitting such information to persons unauthorized to receive the same, it is recommended that if the sentence is approved, a penitentiary in the United States be designated as the place of confinement.

J. M. WAINWRIGHT,

Major General, U. S. Army,
Commanding.

In the foregoing case of Captain Rufo C. Romero (O-18350), Philippine Scouts (CE), 14th Engineers (PS), the sentence is confirmed and will be carried into execution.

FRANKLIN D. ROOSEVELT

The White House,

July 5, 1941.

S.W.G.

General Court-Martial
Orders, No. 10

War Department,
Washington, July 8, 1941.

Before a general court martial which convened at Fort William McKinley, Philippine Islands, November 7, 8, 9, 10, 12, 13, 14, 15, 16, 18, 19, 20, 22, 23 and 25, 1940, pursuant to paragraph 1, S. O. 44, Headquarters, Philippine Division, Fort William McKinley, P. I., October 30, 1940, as amended by paragraphs 2, 3, and 4, S. O. 45, Head-

quarters, Philippine Division, Fort William McKinley, P. I., November 4, 1940, was arraigned and tried——

Captain Rufo C. Romero (O-18350), Philippine Scouts (CE), 14th Engineers (PS).

Charge: "Violation of the 96th Article of War."

Specification 1.—"In that Captain Rufo C. Romero, Philippine Scouts (CE), 14th Engineers (PS), an officer having access to secret maps pertaining to the national defense, to wit: * * * , did, at Fort William McKinley, P. I., on or about October 15, 1940, willfully and unlawfully communicate the said maps to Mariano Cabrera and Anis Y. Gepte, persons not entitled to receive such information."

Specification 2.—"In that Captain Rufo C. Romero, Philippine Scouts (CE), 14th Engineers (PS), did, at Pasay, Rizal, P. I., on or about October 16, 1940, unlawfully reproduce certain official maps, marked "Secret", of military installations, to wit: * * * , without first obtaining permission from the Commanding General, Fort William McKinley, P. I., or higher authority, said maps having no clear indication thereon that they had been censored by proper military authority."

Specification 3.—"In that Captain Rufo C. Romero, Philippine Scouts (CE), 14th Engineers (PS), an officer having access to secret maps pertaining to the national defense, to wit: * * * , did, at Pasay, Rizal, P. I., on or about October 15, 1940, conspire with Mariano Cabrera and Ignaciô

Agbay unlawfully to communicate the said maps to Anis Y. Gepte, a person not entitled to receive such information and to effect the object of said conspiracy did, thereafter on said date, in company with the said Anis Y. Gepte, visit the building at Fort William McKinley, P. I., in which the said maps were stored.”

Specification 4.—“In that Captain Rufo C. Romero, Philippine Scouts (CE), 14th Engineers (PS), did, at Pasay, Rizal, P. I., on or about October 15, 1940, conspire with Mariano Cabrera and Ignacio Agbay unlawfully to reproduce certain official maps, marked “Secret”, of military installations, to wit: * * *, without first obtaining permission from the Commanding General, Fort William McKinley, P. I., or higher authority, said maps having no clear indication thereon that they had been censored by the proper military authorities, and to effect the object of said conspiracy, did, on or about October 16, 1940, remove said maps from their place of storage at Fort William McKinley, P. I., to his home in Pasay, Rizal, P. I.”

To which charge and specifications the accused pleaded “Not Guilty.”

FINDINGS

Of Specification 1: “Guilty.”

Of Specification 2: “Guilty.”

Of Specification 3: “Guilty.”

Of Specification 4: “Guilty.”

Of the Charge: “Guilty.”

SENTENCE

To be dismissed the service, to forfeit all pay and allowances due or to become due, and to be confined at hard labor, at such place as the reviewing authority may direct, for fifteen (15) years.

The sentence was adjudged November 25, 1940.

The following is the action of the convening authority:

HEADQUARTERS PHILIPPINE DIVISION FORT WILLIAM McKINLEY, P. I.

January 14, 1941.

In the foregoing case of Captain Rufo C. Romero (O-18350), Philippine Scouts (CE), 14th Engineers (PS), the sentence is approved and the record of trial is forwarded for action under the 48th Article of War.

(Signed) J. M. WAINWRIGHT,

(Typed) J. M. WAINWRIGHT,

Major General, U. S. Army,
Commanding.

The sentence having been approved by the convening authority, the record of trial forwarded for the action of the President, and the record of trial having been examined by the Board of Review in The Judge Advocate General's Office, and the Board of Review having submitted its opinion in writing to The Judge Advocate General, and the record of trial, the opinion of the Board of Review, and the recommendations of The Judge Ad-

vocate General having been transmitted directly to the Secretary of War for the action of the President, and having been laid before the President, the following are his orders thereon:

In the foregoing case of Captain Rufo C. Romero (O-18350), Philippine Scouts (CE), 14th Engineers (PS), the sentence is confirmed and will be carried into execution.

FRANKLIN D. ROOSEVELT.

The White House,

July 5, 1941.

Captain Rufo C. Romero (O-18350), Philippine Scouts (CE), 14th Engineers (PS), ceases to be an officer of the Army at 12 o'clock midnight, July 10, 1941, and will be confined in the United States Penitentiary, McNeil Island, Washington.

By order of the Secretary of War:

G. C. MARSHALL,

Chief of Staff.

Official:

E. S. ADAMS,

Major General,

The Adjutant General.

EXHIBIT No. 20

United States of America
Commonwealth of the Philippines

In the Justice of the Peace Court of Pasay
Province of Rizal.

No. 121

THE PEOPLE OF THE PHILIPPINES

Versus

CAPT. RUFO ROMERO

100 Del Pan Street
Pasay, Rizal.

SEARCH WARRANT

To Any Officer of the Law:

Whereas on this day proof, by affidavit, having been presented before me by Agents Cesar E. Santos and Santiago L. Safe of Information Division, Philippine Constabulary, that according to confidential investigation and observation there is probable cause to believe that in the house of Capt. Rufo Romero at 100 Del Pan Street, Pasay, Rizal, there are being kept stolen maps belonging to the United States Army.

Therefore, you are hereby commanded during anytime of day and night to make an immediate search on the person of Capt. Rufo Romero and other persons that may be found thereat or in the premises of the above given address for the following property: "Stolen Maps Belonging to United

States Army" and, if you find the same or any part thereof, to bring it forthwith before me in the Justice of the Peace Court of Pasay, Rizal.

Witness my hand this 15th day of October, 1940,
at Pasay, Rizal.

(Signed) IGNACIO SANTOS-DIAZ,
Justice of the Peace,
Pasay, Rizal.

A True Copy:

LEWIS C. BEEBE,
Lt. Col., 57th Inf., (PS),
Trial Judge Advocate.

[Endorsed]: No. 10242. United States Circuit Court of Appeals for the Ninth Circuit. Rufo C. Romero, Appellant, vs. P. J. Squier, Warden, United States Penitentiary, McNeil Island, Washington, Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the Western District of Washington, Southern Division.

Filed September 8, 1942.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals
for the Ninth Circuit

No. 10242

RUFO C. ROMERO,

Appellant,

. vs.

P. J. SQUIER, Warden, United States Peniteñ-
tiary, McNeil Island, Washington,

Appellee.

STATEMENT OF POINTS

1. The District Court erred in holding that a search warrant issued by the justice of the peace of a municipality of a town in the Philippine Islands could be used as the basis of a Federal search and prosecution.

2. The District Court erred in holding that the exclusion from the court room during certain stage of the trial, of appellant's counsel of his own selection, was not a violation of the Sixth Amendment to the Constitution of the United States.

3. The weight of authority that prosecution cannot be had and could not stand, where it appeared that the accused was induced or led to commit the act charged by active cooperation and instigation of public officers, was neglected by the District Court.

4. The District Court erred in holding that the Record of the court martial transmitted to the Judge Advocate General for review and confirmation was not defective even when the maps introduced in evidence were not included.

5. When the court martial violated the constitutional rights of appellant the court martial thereby lost jurisdiction and was no longer a court of competent jurisdiction—it was then the duty of the District Court to release appellant upon writ of habeas corpus.

PEDRO P. SEMSEM,
Attorney for Appellant.

[Endorsed]: Filed Sep. 8, 1942.

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**United States Circuit Court of Appeals
for the Ninth Circuit**

No. 10242

RUFO C. ROMERO, APPELLANT,

vs.

P. J. SQUIER, Warden, McNeil Island, APPELLEE.

BRIEF ON BEHALF OF APPELLANT.

FILED

NOV - 2 1942

**PAUL P. O'BRIEN,
CLERK**

**PEDRO P. SEMSEM,
Attorney for Appellant.
322 C St. S. E.,
Washington, D. C.**



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United States Circuit Court of Appeals for the Ninth Circuit

No. 10242

RUFO C. ROMERO, APPELLANT,

vs.

P. J. SQUIER, Warden, McNeil Island, APPELLEE.

BRIEF ON BEHALF OF APPELLANT.

Jurisdictional Statement.

Jurisdiction in this court is vested by United States Code, Title 28, Sections 452 and 463.

Statement of Case.

This is an appeal from the judgment of the District Court for the Western District of Washington dismissing a petition for a writ of habeas corpus, in which appellant was the petitioner, and the appellee was the respondent. In the District Court appellant submitted that he was unjustly and unlawfully imprisoned by color of authority of the United States, in custody of the warden, McNeil Island, Washington, and the cause or pretext of such detention and imprisonment was a certain order of commitment by

a general court martial held and convened at Fort William McKinley, Philippine Islands, on November 25, 1940, ordering that appellant be imprisoned in said jail for a period of 15 years; that said restraint and detention are illegal and in violation of Article IV and Article VI of the Amendments to the Constitution of the United States; in violation of the Act of June 4, 1920 (chap. 227, subchap. II, Articles 17, 35, 70, 41 Stat. 790, 794, 802); and is contrary to law.

Appellant, Rufo C. Romero (14th Engineers, Philippine Scouts) was charged with violation of the 96th Article of War. There were four specifications of conspiracy to unlawfully communicate certain maps marked secret to certain persons not entitled to receive such communication, and unlawfully reproduced certain maps marked secret (R. pp. 7, 8). The maps were withdrawn at the conclusion of the trial and not made a part of the Record. The importance and secrecy of the maps as emphasized by the prosecution was doubtful and questioned, for they were only old maneuver maps, obsolete, and some of them were of the kind usually used as wrapping paper at the engineer headquarters.

In order to obtain evidence against appellant, one Major J. K. Evans, Chief of Intelligence, Philippine Department, United States Army, employed one Anis Gepte who, in turn, employed the services of two individuals to accomplish the scheme and solicited and induced appellant to show him the maps in question. Major Evans himself testified that he told Anis Gepte what to ask (R. p. 285). It was his instigation, through prosecution's principal witness, Anis Gepte, that the maps were allegedly shown (R. p. 266). The appellant's house where he was searched and arrested was situated outside of the military reservation.

Major Evans made arrangements with officers of the Philippine Constabulary who are possessed of police authority, to secure search warrant (R. p. 273; Tr. p. 148).

A warrant was issued by the justice of the peace of the town of Pasay, Province of Rizal, Philippine Islands (a copy of which was made a part of the Record, Transcript p. 185), directed to any police officer directed to search the residence of appellant for "stolen maps belonging to the United States Army", and if such were found, to bring it forthwith before him in the justice of the peace court of Pasay, Rizal. Major Evans had no warrant from any source (R. p. 290; Tr. p. 151). When all was in readiness according to his plans and instructions, he, in company with the police officers armed with search warrant issued by the justice of the peace, entered the residence of appellant (R. p. 273). He searched the house, took possession of anything that might be used against appellant, arrested him and took him into custody at Fort William McKinley. He also took the articles he seized to Fort William McKinley (R. p. 274; Tr. 150).

During the preliminary investigation, appellant requested the services of one Major Lynch, a retired Army officer and a lawyer of high standing, but the investigating authority denied this request. Then appellant further requested that one Major Poblete, a Filipino U. S. Army officer and a capable lawyer, to represent him. This was also denied by the Army authorities. Finally, at the beginning of the court-martial trial, appellant was allowed to engage a civilian counsel who was a member of the Philippine bar. But at the early stage of the trial the court martial excluded this counsel from the court room (R. p. 202; Tr. 128-29). (See photographic copy of a newspaper of Benjamin de Guzman's letter taken from the Library of Congress on last part of this brief.)

Statement of Points.

1. The District Court erred in holding that a search warrant issued by the justice of the peace of a municipality of

a town in the Philippine Islands could be used as the basis of a Federal search and prosecution.

2. The District Court erred in holding that the exclusion from the court room during certain stage of the trial, of appellant's counsel, was not a violation of the Sixth Amendment to the Constitution of the United States.

3. The weight of authority that prosecution cannot be had and could not stand, where it appeared that the accused was induced or led to commit the act charged by active co-operation and instigation of public officers, was neglected by the District Court.

4. The District Court erred in holding that the Record of the court martial transmitted to the Judge Advocate General was not defective even when the maps introduced in evidence were not included.

5. When the court martial invaded the constitutional rights of appellant the court thereby lost its jurisdiction and was no longer a court of competent jurisdiction—it was then the duty of the District Court to release appellant upon writ of habeas corpus.

Summary of Argument.

I. The District Court erred in denying appellant's contention that the search, seizure, and arrest was unconstitutional when the Federal officer used a police warrant issued by the justice of the peace as the basis of the Federal search and prosecution.

II. Appellant was not given a fair and impartial hearing during the preliminary investigation. Exclusion from the court room of any of appellant's counsel was a clear invasion of his constitutional right; whenever the relation of client and attorney existed appellant had the guaranteed

right of having counsel represent him in *any, all, and every* stage of his case, and the fact that appellant may have been defended by the military counsel does not abridge his right to have counsel of his own selection and as many as he may see proper to defend him.

III. The District Court erred in not holding that the act charged appellant resulted through the direct instigation of the Federal officer and his agents and its commission procured by them.

IV. When the maps introduced in evidence were removed and not included in the Record transmitted to the Judge Advocate General for final review and confirmation, the act of June 4, 1920 (41 Stat. 794) which is also article 35 of the Articles of War, was violated and the Review Board in the office of the Judge Advocate General had no authority to approve the decision of the court martial when the Record was defective.

Argument.

I. The District Court erred in not holding that appellant's constitutional right against unlawful search and seizure was violated when the police warrant was used as the basis of the search and prosecution. The Federal officer indirectly did what he was prohibited from doing directly.

Major Evans made arrangements with the police officers to secure a search warrant; and then accompanied and was one of the leaders of the raiding party.

Major Evans himself had no warrant from any source nor authority to search and arrest appellant. Yet he was the first one to enter appellant's house; searched the premises; took with him everything that could be used against appellant and took him into custody at Fort William McKinley. In substance, the result was that the whole under-

taking was exclusively his own. The basis of the District Court's ruling on this point was the alleged stipulation between the prosecution and defense (which appears on R. p. 297; Tr. 156) as follows:

Prosecution: * * * The prosecution and defense join in stipulating that the search warrant authorizing the search on the premises and person of the accused, at 100 Del Pan Street, Pasay, Rizal, Philippine Islands, on October 16th, 1940, was issued and executed by competent authority under the laws of the Philippine Commonwealth. This stipulation is being made to permit the continuance of the trial at this time, and with the understanding that the original of the search warrant will be produced in court at a later date.

This stipulation was nothing but merely an understanding that the search warrant was issued out of a competent authority, the justice of the peace, and its execution by police officers under the laws of the Philippine Commonwealth. It was not a stipulation that Major Evans had an authority to enter and search appellant's premises nor was it stipulated that Major Evans was competent to execute a warrant issued by a civil court of the Philippines. Furthermore, the accused has the constitutional right to be safeguarded against unlawful search and seizure, and counsel cannot make stipulations which operate as a surrender of his substantial rights (*Ball v. Bank of State*, 8 Ala. 590, 42 Am. Dec. 649; *Wabash, St. L. & P. R. Co. v. McDougall*, 18 N. E. 291). Stipulations by counsel as to matter of law have also been held to be of no effect (*New Jersey Title Guarantee & T. Co. v. McGrath*, 224 Fed. at p. 759). Also, counsel has no authority to surrender the rights possessed by his client. Nor could counsel bind his client by admission or stipulation prejudicial to the client's cause of action or defense (2 R. C. L. 990). This procedure followed by Ma-

for Evans was objected to by appellant's military counsel (R. p. 294; Tr. 153):

Defense Counsel: May it please the court, the defense, at this time, objects to the admissibility of this evidence until it is proven that the search was legally conducted. It is true the witness has testified that he had in his possession a search warrant, but so far, there is nothing to show that the warrant was legally issued, nor that it directed a search of the house of Captain Romero, nor for what purpose the warrant was issued. These facts, I believe, should be proven before the testimony is admitted.

and by appellant himself (R. p. 555; Tr. 177) in this term: “* * * I believe, therefore, that these maps should be rejected as evidence, because Major Evans has no authority to execute a search warrant issued by civil courts of the Philippine Islands. * * *”

The question then arises whether Major Evans, not vested with police authority, could execute a search warrant issued out of a justice of the peace in the Philippine Islands; and if such warrant could be used as the basis of a Federal search and prosecution. Various Federal courts, including the Supreme Court of the United States, had occasion to rule on this question and they are unanimous in holding that a state or police warrant when executed by Federal officers, may not be used as the basis of a Federal prosecution. That would be a violation of an accused's constitutional right against unlawful search and seizure guaranteed him under the Fourth Amendment. (*Garske v. United States*, 1 F. (2d) 620; *United States v. Costanzo*, 13 F. (2d) 259; *Mann v. Commonwealth*, 279 S. W. 1079; *United States v. Spallino*, 21 F. (2d) 567; *Byars v. United States*, 273 U. S. 28.)

In the case of *Byars v. United States*, *supra*, the warrant to search described premises was in the hands of local po-

lice officers and accompanied by a Federal agent. The Federal agent had no warrant nor authority to enter the residence. The search and seizure was made entirely upon the authority of the police warrant. The Federal agent found some unlawful stamps and kept them together with those found by the other members of the raiding party. In this instance the Court stated that:

“Whether the warrant was good under the local laws is not necessary to inquire, since in no event could it constitute the basis for a Federal search and seizure. Nor was it material that the search was successful in revealing evidence of a violation of a Federal statute. A search prosecuted in violation of the Constitution is not made lawful by what it brings to light. While it is true that the mere participation in a state search by one who is a Federal officer does not render it a Federal undertaking, the Court must be vigilant to scrutinize the attendant facts with an eye to detect, and a hand to prevent violations of the Constitution by circuitous and indirect methods. Constitutional provisions for the security of persons and property are to be liberally construed, and it is the duty of the courts to be watchful for the constitutional rights of the citizen, and against any stealthy encroachments thereon. The participation of the Federal officer was under color of his Federal office and the search in substance and effect was the joint operation of the local and Federal officers. In that view, so far as the inquiry is concerned, the effect is the same as though he had engaged in the undertaking as one exclusively his own.”

An unlawful search cannot be justified by what is found. It was against such prying, on the chance of discovery, that the constitutional amendment was intended to protect the people. *United States v. Slusser*, 270 F. 818; *United States v. Bush*, 269 F. 455; *United States v. Costanzo*, *supra*.

II. Appellant was denied the right to be represented by counsel of his own selection. At the preliminary investiga-

tion he requested the assistance of a Major Lynch, who was a member of the Philippine bar, but the military authorities denied the presence and assistance of this counsel, as verified by the following statement of appellant:

“Shortly before the investigation of the charges against me, I was permitted to see a lawyer—a certain Mr. Lynch—an American. At the investigation Mr. Lynch was not allowed to be present, and in answer to a letter of his, respectfully inquiring why he was denied attendance in spite of my request, he was told that it was not necessary that he be present. Mr. Lynch thereupon resigned as my counsel, remarking that the attitude of the military authorities was such that there was nothing he could do for me. My investigation was thus conducted without the benefit of counsel.”

Then he requested the services of one Major Poblete, an Army officer and capable barrister, to represent him in the defense of his case, but this request was also denied. The testimony of two witnesses against appellant, during the investigation, was taken not in the presence of the accused, though this testimony was used against him in support of a recommendation for court-martial trial. It clearly shows that appellant was not given a fair and impartial hearing during the investigation. The assistance of counsel is essential to a fair hearing, and he is to be allowed the presence and advice in the preliminary investigation. If an accused was denied counsel at the preliminary investigation, he was not accorded the fair and impartial hearing guaranteed to all persons whose liberty is involved (*Ex parte Lam Pui*, 217 Fed. 456). In order to afford an accused a hearing consistent with the due process clause of the Constitution the government must allow him a fair opportunity and the right to secure counsel of his own choice. (11 Am. Juris. 1107; *Ex parte Chin Loy You*, 223 Fed. 833.) By direction of the

President, the War Department, under date of December 29, 1938, issued Circular No. 79, for the purpose of giving persons fair and impartial trial, which provides: "No charge shall be recommended for trial by general court-martial unless, prior to such action, the thorough and impartial investigation thereof required by A. W. 70 shall have been made by an officer." * * * "No charge will be referred to a general court-martial for trial until after a thorough and impartial investigation thereof shall have been made." Examination of the preliminary proceedings in the Record shows that no counsel appeared for appellant. Likewise, no counsel represented and prepared his defense from the time of his arrest to the day of his trial. In the famous Scottsboro trial, *Powell v. Alabama*, 287 U. S. 85, the defendants were represented by counsel appointed by the court in the preliminary hearing. No counsel prepared the case for the defense between the preliminary hearing and the day of trial. And when the trial started, the court appointed all the members of the bar in the city, and about two lawyers agreed to participate for the defense. The Supreme Court of the United States ruled that the defendants were not given effective aid so as to make it a fair trial, and they were not represented by counsel within the meaning of the Sixth Amendment to the Constitution.

At the beginning of the trial a military counsel was appointed for the defense and a civilian attorney who was a member of the Philippine bar, was recognized as one of the appellant's counsel. But at the early stage of the proceeding especially when the maps were to be introduced in evidence, the court martial excluded this civilian counsel from the court room. While it could be stated that the court martial acted in pursuance of a certain Army regulation as to divulgence of military matter to non-military personnel, appellant submits that such regulation is not superior enough to override the Constitution of the United

States which guarantee an accused the right to be represented by counsel at any, every, and all the stages of a proceeding. When the court martial recognized the civilian counsel, he thereby became an officer of that court—a part of that court. When the counsel was excluded, the court martial became incomplete and was no longer a court of competent jurisdiction (*Johnson v. Zerbst*, 304 U. S. 458). It would be disregarding and abridging the trust and confidence bestowed upon attorneys in the court rooms. They are entitled to be trusted to all secret and confidential matters before the court, otherwise would be defeating the intent and purpose of the statute and the Constitution. The District Court was of the opinion that appellant was always represented by counsel because the military defense counsel was always present, and no objection was raised when the civilian defense counsel was ejected. But it was not that type of representation that would have given effective aid, and the type that would fulfill the requirement of the Sixth Amendment. It must be remembered that the military defense counsel was not a member of any bar. A defendant is entitled to be represented not only by one who is a member of the bar but by a competent counsel—a capable practitioner (*Achtien v. Dowd*, 117 F. (2d) 989). The accused has the right to have all his counsel represent him during his entire trial, and it is reversible error to exclude them, or any one of them, from the court room at any stage of the trial (Cooley's Constitutional Limitations, p. 703). Exclusion from the court room of any of his counsel is a clear invasion of his constitutional right notwithstanding the other counsel who remain are capable of taking care of his interests (*Jackson v. State*, 115 S. W. 262). In this case the court laid the principle that:

“The defense of an accused by counsel is a very valuable right, and one which is guaranteed him by our Constitution and laws, and whenever the relation of

client and attorney exists the accused has the guaranteed right of having counsel represent him at any, all, and every stage of his case while before the court. The fact that accused may have been ably defended by other counsel does not abridge his right to have counsel of his own selection, and as many as he may see proper to employ to defend him.”

In *Johnson v. Zerbst*, 304 U. S. 458; decided May 23, 1938, the Supreme Court of the United States stated the principle, which is universally followed, as follows:

“A person charged with crime is entitled by the Sixth Amendment to the Constitution to the assistance of counsel for his defense. The right may be waived, but the waiver must be an intelligent one, and whether there was such must depend upon the circumstances and particular facts, including background and conduct of the accused. If the accused is not represented by counsel and has not waived his constitutional right, the Sixth Amendment stands as a jurisdictional bar to a valid conviction and sentence depriving him of his life or his liberty. The Sixth Amendment withholds from Federal courts, in all criminal proceedings, the power and authority to deprive an accused of his life or liberty unless he has or waives the assistance of counsel. *Barron v. The Mayor*, 7 Pet. 243; *Edwards v. Elliott*, 21 Wall. 532, 557.

True, habeas corpus can not be used as a means of reviewing errors of law and irregularities—not involving question of jurisdiction—occurring during the course of the trial; and the writ of habeas corpus cannot be used as a writ of error. These principles, however, must be construed and applied so as to preserve—not destroy—constitutional safeguards of human life and liberty. The scope of inquiry in habeas corpus proceedings has been broadened—not narrowed—since the adoption of the Sixth Amendment. Congress has expanded the right of a petitioner for habeas corpus.

Since the Sixth Amendment constitutionally entitles one charged with a crime to the assistance of counsel, compliance with this constitutional mandate is an essential jurisdictional prerequisite to a Federal court's authority to deprive an accused of his life or liberty. A court's jurisdiction at the beginning of a trial may be lost "in the course of the proceedings" due to failure to complete the court as the 6th Amendment requires. If this requirement of the Sixth Amendment is not complied with, the court no longer has jurisdiction to proceed. The judgment of conviction pronounced by a court without jurisdiction is void, and one imprisoned thereunder may obtain release by habeas corpus."

In *Smith v. O'Grady*, 61 Sup. Ct. 572 (decided Feb. 17, 1941), the Supreme Court of the United States stated that the Constitution is the supreme law of the land, and the obligation to guard and enforce every right secured by the Constitution rests on the State courts and equally with the Federal courts, and judgments rendered in violation of it cannot stand.

When appellant's constitutional right against unreasonable search and seizure was violated, and further denied the assistance of counsel of his selection, any proceedings thereafter was a denial of due process of law as secured by the Fifth Amendment to the Constitution and such proceedings are void, and the court martial no longer has authority to proceed, and was no longer a court of competent jurisdiction. (*Byars v. United States*, supra; *Powell v. Alabama*, supra; *Johnson v. Zerbst*, supra; and *Smith v. O'Grady*, supra.)

III. Prosecution cannot be had where it appears that the accused was induced or led to commit the act charged by active cooperation and instigation of public officers.

There is no doubt that the act complained of was at the direct solicitation and instigation of Major Evans and

his agent. The alleged co-conspirators, Agbay and Cabrera, and the prosecution's principal witness, Anis Gepte, agreed among themselves to frame-up appellant. The witness, Agbay, testified that he was solicited and offered reward by the government agent, Gepte, to "frame-up" Captain Romero (R. p. 447; Tr. p. 167), as shown in the following testimony:

Question: Did you receive any offer of reward or pay?

Answer: Yes, sir.

Question: What was offered you?

Answer: Cash was the offer, and promise of a position as secret service or agent of the Philippine Constabulary, in case we will be successful in the case he is after.

Question: What case was that?

Answer: The case—the frame-up case that he proposed to me.

Question: And who was the party to be framed?

Answer: Captain Romero.

The witness Cabrera testified to the same effect (R. pp. 513, 524-25; Tr. pp. 171-172). The prosecution's principal witness, Gepte, testified that it was at Major Evans' instigation that the maps were solicited and shown to him (R. p. 266). Major Evans testified that he told his agent, Gepte, what maps to ask and be shown (R. p. 285; Tr. 150). On cross-examination Major Evans testified:

X Q. The witness Gepte testified among other things that you told him to obtain the plan of the defense of Bataan or of the Philippines, I cannot recall which.

A. I myself testified that I told him what to ask. * * *

It is reasonably clear that the Government officer and his agent were not engaged in detecting crime, but they instigated and created the act and procured its commission. This type of procedure and practice by public officers is

denounced by the courts as scandalous and against public policy. This practice cannot be tolerated and conviction of crime or offenses so procured cannot stand. (*United States v. Healey*, 202 F. 349; *United States v. Adams*, 59 F. 674; *Dalton v. State*, 39 S. E. 468.)

In the case of *United States v. Healey*, supra, the court substantially said:

“Decoys are permissible to entrap criminals, or to present opportunity to those having intent or who are willing to commit crime, but not to create criminals, or to ensnare the law-abiding into committing an offense without intent to do so. One is relieved of the obligation by the government’s invitation, which is in the nature of fraudulent concealment and deceit, and if not consent, yet does work an estoppel. If the accused violated a statute, he was the passive instrument of the government, and his is a blameless wrong for which he cannot be justly convicted. That the accused is suspected of any violation of law, does not justify instigating and entrapping; for thereby a law-abiding person may as easily be ensnared. This practice cannot be tolerated and conviction of offense so procured cannot stand.

In *United States v. Adams*, supra, the court stated the principle that courts will not lend aid or encouragement to government officers who may, under a mistaken sense of duty, encourage and assist parties to commit crime in order that they may arrest and have them punished for so doing. The encouragement to persons or criminals to induce them to commit crime in order to get a prosecution against them is scandalous and reprehensible.

The only time appellant met the individuals was a day before his arrest when he was solicited about the maps. As among appellant’s duties was the investigation of subversive activities he consented to this request, to impress upon them that appellant had access to some maps and able

to reproduce them, so that the alleged principal, the mythical sultan, would be brought before him with the idea of having him arrested.

The Merit of the Case.—The specifications charged that appellant conspired to communicate secret maps to persons not entitled to receive the communication. The Record shows that Gepte, the prosecution's principal witness, was working for Major Evans and received instructions from him. Gepte for himself employed the two alleged co-conspirators, Agbay and Cabrera, to work for him to solicit the act. The result, then, was that all these three individuals were the agents of Major Evans. Since Major Evans, a United States Army officer, was entitled to see the maps, it could not be legally stated that the maps were shown to unauthorized persons or persons not entitled to receive the communication. Furthermore, the contents of the maps were not understood by the witness and co-conspirators. The witness, Gepte, could not identify the contents, nor the maps he alleged he saw. In order to have communication, there must be an understanding and meetings of the minds. When Gepte approached appellant the pretense was that a certain sultan in Mindanao (no such person in existence) desired to buy some maps. Since the supposed buyer was but a mere imaginary person, a mythical sultan, no crime could have been committed, nor an intent to commit a crime imputed to appellant.

IV. The act of June 4, 1920 (41 Stat. 794) and articles 35 and 50½ of the Articles of War were violated when the maps introduced in evidence were withdrawn and not included in the Record transmitted to the office of the Judge Advocate General. The article of war involved is as follows:

“Article 35: The trial judge advocate of each general court-martial shall, with such expedition as cir-

cumstances may permit, forward to the appointing authority or to his successor in command the original record of the proceedings of such court in the trial of each case. All the records of such proceedings shall, after having been acted upon, be transmitted to the Judge Advocate General of the Army.”

The court martial had no authority to withdraw the maps introduced in evidence. It was the intent of the statute to transmit all the evidence introduced, and nothing should be withdrawn regardless of its class or nature. This is verified by part of section 75, Manual for Courts Martial, page 59:

“Where a document, which must or should be returned to the source from which it was obtained (e. g., an original record), is received in evidence or marked for identification, a suitable copy or extract copy thereof, certified as such by the trial judge advocate, will be substituted for such document so as to permit of such return.”

The importance of the maps as emphasized by the prosecution had been doubtful. The testimony of some of their own witnesses lead to this assertion. Those maps were part of no secret or war plans, but were simply maps containing some data of past maneuvers. A prosecution witness testified that the maps were obsolete and of no further use, and were to be turned in, according to the usual procedure, to the office of the Department Engineer at Manila (R. p. 363). Some of the maps were of the type habitually used as wrapping and sketching paper at the engineer headquarters (R. p. 365). The obsolete maps found in the trunk of appellant's automobile were to be returned to the Department Engineer at Manila (R. pp. 363, 368, 370). While it is true that there were other maps found in appellant's residence at the time of his arrest, it is equally true that, since he was a topographical officer of the

14th Engineers, he kept such maps in his quarters for one of the following purposes: To study or correct them; to use them in preparation for reconnaissances, maneuvers, or surveys; and to use them in trips taken for map correction purposes.

The maps were the gist of the evidence from which appellant was convicted, yet they were not included in the Record transmitted to the Judge Advocate General. The review board which was to review and approve the decision had no authority to approve the sentence of the court-martial when the Record was so defective. The Attorney General of the United States had occasion to interpret Article of War 35, and stated his opinion on what must be included in the Record. In 3 *Op. Atty. Gen.* 545, the Attorney General stated:

“It is not sufficient to return the inference or conclusions of the court-martial nor mere statements of the evidence inspected; but the evidence itself on which they based judgment must be returned. It is improper for the reviewing authority to make any decision in regard to the effect of a certain act of Congress, in cases where the Record is so defective. The Record would not exhibit the facts of the case in such form as would have authorized the review board to pass upon them. As no sentence of a general court-martial can, pursuant to the act of Congress of June 4, 1920, article of war 50½, be carried into execution until it is approved by the review board for transmission to the President for confirmation, it is essential that the Record should contain all the evidence; and that, in order to a confirmation, such evidence should sustain the finding of the court. It would not be proper for the reviewing authority to make any decision in regard to the effect of the act of Congress of June 4, 1920, when the Record is defective in presenting, in the usual and legal form, the facts on which the correctness of such decision must depend.”

The District Court had the opinion that if the maps were included in the Record, they may have been published and their contents divulged to the public. This is not so. The United States Army in the Philippines used to send maps and matter to the War Department in Washington, D. C., which were of the highest secret and confidential nature. There was no possibility of the public getting access to such matter. The deliberations of the Review Board in the office of the Judge Advocate General are confidential and the public nor the press had no access to such deliberations.

It seems very interesting and material to note part of the District Court's oral opinion which states as follows: "If the petitioner had a civilian attorney and no other counsel and if such civilian counsel had been excluded for a while from the proceedings Mr. Semsem would have had a very much more favorable case. Likewise, if the then defendant had objected to the proviso that the maps were to be later removed Mr. Semsem would have had very much more of an opportunity now to get the results he seeks." As to the exclusion of counsel, it has been discussed briefly in Argument No. II. With regards to the alleged failure of appellant to object to the withdrawal of the maps, it cannot be legally stated that appellant nor his military counsel did not object. It was the administrative duty of the court-martial and the trial judge advocate to preserve and put in the Record all the evidence introduced or inspected, as required by the statute—there is no alternative for them to follow—they have only one mandatory duty regarding the evidence inspected—the duty to include in the Record the maps that were put in evidence. Furthermore, the objection was not waived, and there was no waiver of objection where a formal objection should have been raised, according to a provision in the Manual for Courts Martial. Therefore appellant was deemed to have objected in every instance in the proceedings, although no verbal objection

was formally raised. This is supported by subsection (c) pages 136 and 137, Manual for Courts Martial, which is as follows :

c. Waiver of objections.—The prosecution or defense may in open court either orally or in writing waive an objection to the admissibility of offered evidence. Such a waiver adds nothing to the weight of the evidence nor to the credibility of its source. The court in its discretion may refuse to accept, and may permit the withdrawal of, any such waiver. There is no prescribed form for making a waiver. Thus, if it clearly appears that the defense or prosecution understood its right to object, any clear indication on its part that it did not desire to assert that right may be regarded as a waiver of such objection. *However, a waiver of an objection does not operate as a consent where consent is required, and a mere failure to object does not amount to a waiver except as otherwise stated or indicated in this manual.* (Emphasis supplied.)

The point herein involved not being specifically indicated in the Manual for Courts Martial as one that should have been formally objected, it therefore stands that appellant did not consent nor waived the objection to the withdrawal of the maps from the Record. Appellant had objected to the admission of the evidence on the ground that it was unlawfully seized. Likewise, appellant did not consent to the exclusion of his counsel of his own selection.

Authority of a court martial is derived from the statute, and it must proceed in conformity therewith. Being an inferior court of limited jurisdiction, its judgments may be attacked collaterally, and the validity of its proceedings can be revised upon a hearing in habeas corpus (*Mc-Claughry v. Deming*, 186 U. S. 49; *Runkle v. United States*, 122 U. S. 543). In *Dynes v. Hoover*, 61 U. S. at p. 81, the Court said: "Persons belonging to the Army and Navy are not subject to irresponsible courts martial, when the law

for convening them and directing their proceedings or organization and for trial have been disregarded. In such cases everything which may be done is void—not voidable; and civil courts have never failed, upon a proper suit, to give a party redress, who has been injured by a void process or judgment. In *McClaughry v. Deming*, supra, the Court stated that to give effect to its sentence, it must appear affirmatively and unequivocally that the court martial was legally constituted, that it had jurisdiction, that all the statutory regulations governing its proceedings had been complied with, and that its sentence was conformable to law. The absence of any of these indispensable conditions renders the sentence and judgment of a court martial *coram non judice*, and absolutely void, because such judgment and sentence is rendered without authority of law and without jurisdiction (*Mills v. Martin*, 19 Johns. (N. Y.) 17; *Smith v. Shaw*, 12 Johns. (N. Y.) 257).

Conclusion.

The judgment of the District Court should be reversed, and a writ of habeas corpus be issued by this Honorable Court directed to the Warden, McNeil Island, Washington, and that your appellant be ordered discharged from detention and imprisonment thereat. And for such other and further relief as to the Justices of this Court may appear and seem just and proper.

Respectfully submitted,

PEDRO P. SEMSEM,
Attorney for Appellant,
 322 C St. S. E.,
 Washington, D. C.



His letter sent to the court this morning follows:

"5 Cementina, Pasay, Rizal
"November 13, 1940

"The President

"Court Martial

"Fort William McKinley

"Sir:

"I have the honor to submit herewith my withdrawal as associate defense counsel of Captain Rufo C. Romero for the reasons stated below. In this connection it behooves me to express myself with the same frankness with which the American people are reputed to be. Before proceeding, however, allow me to give a brief summary of the incidents which occurred before the trial of the accused.

"At the very outset the accused Captain Rufo C. Romero engaged the services of Major Thomas A. Lynch to act as his chief defense counsel. Major Lynch, however, had to withdraw in disgust because his communications with the proper authorities at Fort Wm. McKinley were not given proper attention. Then the accused requested for the services of Major Ricardo Poblete and the latter was willing to act as the chief defense counsel of the accused. However, this request after being held in abeyance for sometime was finally turned down by the Chief of Staff of the Philippine Army. This being the case the accused gave up all hopes of choosing the officer to defend him and left this matter entirely in the hands of the U. S. Army authorities. Hence Major Johnston and Captain Ivy were appointed to act as defense counsel of the accused. With this as background, I shall now state the reasons why I withdraw from this case.

"First of all, I feel that the chief defense counsel and his assistant

are not sincerely aiding the accused. On the contrary they are at times only strengthening the case of the prosecution by their silence. The claim that the best interest of the accused could be better served by keeping silent is too far-fetched. I, as mere associate defense counsel, cannot of course go beyond what the chief defense counsel desires.

"In the second place, the accused is not given a fair chance to have his mental condition examined by alienists. After the motion to have the accused examined by medical officers of the U. S. Army has been denied, a request was made to the proper authorities to allow civilian alienists to examine the mental condition of the accused. However, before this request could ever be approved by the commanding officer, the trial judge advocate who is the chief prosecuting officer in this case is given a hand to approve or disapprove the request before the commanding officer gives his final approval. In other words the accused is left at the mercy of the prosecuting officer.

"In the third place I feel that my presence in the court martial is not pleasant to its members. With my withdrawal, the court can now go on with its desire. The accused is even willing to waive his presence in court. Therefore, the prosecution, the court, the defense counsel and the public opinion can now have their 'pound of flesh.' But before I close may I hope that this letter of mine shall serve as warning to the end that we may not witness in this country what Hitler appropriately calls 'the baptism of blood.'

"Very truly yours,

"BENJAMIN C. DE GUZMAN

"Associate defense counsel of
"the accused Rufo C. Romero

"(Capt. P.S.)"

IN THE
United States
Circuit Court of Appeals
FOR THE NINTH CIRCUIT

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VS.

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Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE UNITED
STATES FOR THE WESTERN DISTRICT OF WASHINGTON,
SOUTHERN DIVISION

HONORABLE LLOYD L. BLACK, *Judge*

BRIEF OF APPELLEE

FILED

NOV 30 1942

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IN THE
United States
Circuit Court of Appeals
FOR THE NINTH CIRCUIT

RUFO C. ROMERO,

Appellant,

vs.

P. J. SQUIER, Warden United States
Penitentiary, McNeil Island, Washington,

Appellee.

UPON APPEAL FROM THE DISTRICT COURT OF THE UNITED
STATES FOR THE WESTERN DISTRICT OF WASHINGTON,
SOUTHERN DIVISION

HONORABLE LLOYD L. BLACK, *Judge*

BRIEF OF APPELLEE

STATEMENT OF THE CASE

Appellant herein filed a petition for a writ of habeas corpus in which petition he alleged: (1) that he was a citizen of the Philippine Islands; (2) that he was unjustly and unlawfully detained and imprisoned by color of authority of the United States, in the cus-

when a certain police warrant issued by the Justice of the Peace of Pasay, Philippine Islands, was used as the basis of search and prosecution.

(2) Appellant was not given a fair and impartial hearing during the preliminary investigation.

(3) That the exclusion from the courtroom of any of appellant's counsel was a violation of his constitutional rights.

(4) That that violation concerning which appellant was charged and convicted was a clear case of entrapment.

(5) That by failure to make the secret maps part of the record, the whole proceedings were void.

Counsel, in this brief, will only mention the points and authorities that seem pertinent to him. For a more thorough analysis of the law and facts involved, reference is hereby made to the exhaustive review of the law and facts occurring during the trial by court-martial, as found in Review of the Staff Judge Advocate (T.R. 55-104), and the oral opinion of the District Judge, Honorable Lloyd L. Black (T.R. 31-52.)

Counsel for appellant relies upon the leading cases of *Johnson v. Zerbst*, 304 U. S. 458, and *Powell v. Alabama*, 287 U. S. 45, cases quoted in all habeas

corpus proceedings, and argues that the special state of facts surrounding this particular case brings it within the doctrine of those cases. There is, however, in this case no similarity between the facts as set forth in the *Zerbst* and *Powell* cases and the one concerning which we are involved.

SEARCH WARRANT AND ENTRAPMENT

In the present case, a search warrant was regularly issued (T. R. 152). It was served by Augustine G. Gabriel, Captain, Philippine Constabulary, residing in Manila, Philippine Islands (T.R. 152). It was obtained by two agents from his office (T.R. 154). On his entry into the house, the officer told the appellant that he had a search warrant with him, and that it was his duty to inform appellant and his wife, and if necessary, to read the contents of the warrant to them. Appellant and his wife both told the officer that there was no necessity to read the same, that they might search the house (T.R. 155).

The search warrant itself was made a part of the Record of the court-martial proceedings.

In those proceedings likewise a stipulation was entered into between the prosecution and appellant,

a copy of said stipulation being found on page 156 of the Bill of Exceptions and on page 6 of appellant's brief.

With a search warrant duly issued, its legality admitted by the defendant, and a search made under it, how can appellant at this time raise an issue, not under appeal, but under a petition for writ of habeas corpus?

Counsel for appellant doesn't contend that the constabulary could not make the search. His objection is that Major Evans was not authorized to be present, that his presence voided the search.

ENTRAPMENT

On the question of entrapment there was a clear question of fact, decided adversely to appellant in the court-martial proceedings.

The solicitation was not initiated by Major Evans nor by Gepte — a secret operative of the Philippine Army. The proposal to Gepte was made by one Agbay — (T.R. 72) who was acting as go-between for one Cabrera. Cabrera and Agbay offered to sell secret maps of the defenses in the Philippine Islands to Gepte. This offer was disclosed to Major Evans. The

latter suspecting that the appellant was the Army officer who was selling secret information to the Japanese, instructed Gepte to accept the offer (T.R. 74).

As a result appellant, Cabrera and Agbay were caught in the act with photographic maps of the defenses of the Philippine Islands in their possession.

There was a conflict in the evidence, to be sure, but that conflict was decided adversely by the court-martial. Its findings are of course binding on this court.

WAIVER

Two serious questions might have been involved in this action, had not appellant waived same.

(1) Was appellant denied the right of civilian counsel?

(2) Was a complete record sent to the Reviewing Board?

Appellant was entitled to civilian counsel, *Title 10 U.S.C.A. Sec. 1488*.

“ * * * The accused shall have the right to be represented in his defense before the court by counsel of his own selection, civil counsel if he so provides, or military if such counsel be reasonably available, otherwise by the defense counsel

duly appointed for the court pursuant to Article 11. Should the accused have counsel of his own selection, the defense counsel and assistant defense counsel, if any, of the court, shall, if the accused so desires, act as his associate counsel."

In accordance with this provision Major Howard D. Johnston and Captan James M. Ivy were detailed as Defense Counsel. Appellant retained Benjamin C. De Guzman as Civilian Counsel.

He distinctly stated, however, that he wanted Major Johnston and Captain Ivy to conduct the defense, and De Guzman to act as associate and assistant counsel. (T.R. 110).

Appellant was a graduate of West Point and had been in the Service for practically ten years, as an officer in the United States Army.

Throughout the entire proceedings Major Howard D. Johnston, counsel of his own choice, represented him. Appellant personally was present during the entire proceedings.

Appellant and his military counsel were allowed to examine the secret maps introduced in evidence. Prior to the introduction of the maps, however, appellant was informed that only military officers would be allowed to examine the maps. To this appellant made no objection. (T.R. 128).

During the time that these secret maps were being introduced and examined, civilian counsel was absent from the court room.

He returned immediately afterwards, however. (T.R. 144).

Later with appellants consent, both De Guzman and Captain Ivy withdrew from the case. (T.R. 145).

Appellant was asked by the President of the Court if he requested any other officer besides Major Howard D. Johnston appointed to assist in the defense.

Through his counsel, he stated that he did not. (T.R. 147).

THE RECORD

Appellant likewise consented that the secret maps be not made a part of the record.

“Trial Judge Advocate: The Prosecution has no further questions, but desires authority to withdraw the maps under discussion from the record because of their secret nature, at the conclusion of this trial.

“Defense Counsel: No objection from the Defense.

“Law Member: Since there is no objection they may be withdrawn.” (T.R. 144).

AUTHORITIES

As to entrapment, the law is well settled:

“Where the doing of a particular act is a crime regardless of the consent of anyone, the courts are agreed that if the criminal intent originates in the mind of the accused, and the criminal offense is completed, the fact that an opportunity is furnished, or that the accused is aided in the commission of the crime in order to secure the evidence necessary to prosecute him therefor, constitutes no defense. * * *”

Annotation with cases cited — *18 A. L. R. 146.*

In this case, the first solicitation came from Agbay and Cabrera — neither of whom were United States officers. They offered the maps for sale. All Major Evans did was to furnish them the opportunity. There was no solicitation of appellant. Appellant's crime was detected, when he was in the act of furnishing Cabrera, Agbay and Gepte with copies of secret maps, the originals of which had been unlawfully taken by appellant from the Division Headquarters, and photographed.

Search Warrant

The search warrant was legally issued, and was served by officers duly authorized to execute the same. (See stipulation heretofore referred to.) The presence of Major Evans did not void the search by the

proper officials. *Nuckols v. United States*, 99 Fed. (2d) 353.

Presence of Counsel

Accused was a graduate of West Point Military Academy. He was an officer of ten years standing in the United States Army. He consented to his civilian counsel withdrawing from the courtroom when the maps in question were offered. He was at all times represented by Defense Counsel, Major Howard D. Johnston. He now complains that civilian counsel was not present at the investigation. Neither the law nor the Constitution provides for the presence of counsel at an investigation. Even if it did, appellant waived the same, and having waived presence of counsel cannot complain.

Lewis v. Johnston, 112 Fed. (2d) 451,

Franzeen v. Johnston, 111 Fed. (2d) 817.

As to the necessity of the maps being withdrawn from the record, counsel for appellant says:

The record is secret, why couldn't the same be transmitted to the Reviewing Board.

The answer is found in the statute, *Title 10, U. S. C. A. Sec. 1583*:

"Every person tried by a general court-martial shall, on demand therefor, made by himself or by

any person in his behalf, be entitled to a copy of the record of the trial."

The Articles of War

The Articles of War are found in *Chapter 36, Title 10 U.S.C.A.* Every requirement of the Articles relating to the investigation prior to the charge, the charge itself and the formation of the court was complied with.

Appellant was an officer in the United States Army. He was subject to trial therefore by general court-martial. *Title 10 U.S.C.A. Secs. 1471 to 1473.*

The court-martial had jurisdiction over the subject-matter. *Title 10 U.S.C.A. Sec. 1483.*

Accused was given the right of challenge. He consented to the personnel of the court. (T.R. 112) The record was duly authenticated. The sentence was approved by the commanding officer. The record was reviewed by the Board of Review, by the Staff Judge Advocate and by the Judge Advocate General prior to being submitted to the President. The President of the United States entered an order by which the sentence was confirmed and directed to be carried into execution. (T.R. 184.)

Appellant's rights were protected at every stage in the trial. The sentence having been duly confirmed, the decision of the court is final.

Carter v. Roberts, 177 U. S. 496 44 L.Ed. 861,

In re Davison, 21 Fed. 618,

In re Zimmerman, 30 Fed. 176.

In 25 *Am. Jur.*, *Habeas Corpus*, Sec. 28, p. 162, we find:

"Habeas corpus is not a corrective remedy, but is concerned only with defects in a proceeding which operate to render a judgment rendered, or process issued, therein absolutely void. It cannot be invoked for use in correcting mere errors or irregularities in the proceedings of a trial court which are not jurisdictional and, at the most, render a judgment merely voidable. The writ of habeas corpus was neither intended to have, nor does it have, the primary function of a proceeding for the review of errors committed by a trial court within its jurisdiction, and consequently, it does not have the force and effect of such a proceeding as an appeal, error proceeding, or writ of certiorari. The proper scope of the remedy of habeas corpus as a means of a collateral attack upon a judgment or process which is absolutely void is not to be distorted by an attempt to make the proceeding available as one in the nature of an appeal or error proceeding, even though, in the particular case, the latter is not available to the petitioner. In other words, a writ of habeas corpus is not a writ of error or a writ in anticipation of error and cannot operate as, be converted into, or serve as a substitute for such writ, even after verdict, to review non-jurisdic-

tional errors and irregularities leading up to the judgment under which the petitioner is restrained, such, for example, as irregularities in disregarding established rules governing trial procedure, irregularities in docket entries, and error in the modification of an erroneous order, notwithstanding they may be flagrant and serious, or even errors and irregularities in the judgment or sentence itself, if they are not defects of a jurisdictional character."

Quoting:

Keizo v. Henry, 211 U. S. 146; re
Moran, 203 U. S. 96;

McNamara v. Henkel, 226 U. S. 520;

Valentina v. Mercer, 201 U.S. 131;

Charlton v. Kelly, 229 U. S. 447;

Ex parte Parks, 93 U. S. 18.

In *United States v. John Grimley*, 137 U. S. 34 L.Ed. 636, a soldier found guilty by a court-martial for desertion petitioned the court for writ of habeas corpus, the court said, in reversing the lower court:

" * * * It cannot be doubted that the civil courts may in any case inquire into the jurisdiction of a court-martial, and if it appears that the party condemned was not amenable to its jurisdiction, may discharge him from the sentence. And, on the other hand, it is equally clear that by habeas corpus the civil courts exercise no supervisory or correcting power over the proceedings of a court-martial; and that no mere errors in their proceedings are open to consideration. The single inquiry, the test, is jurisdiction. * * *"

The above case follows the principle laid down in *Ex parte Reed*, 100 U. S. 13, 25 L.Ed. 538, where a naval officer petitioned for writ of habeas corpus, claiming he had been sentenced after the court-martial was dissolved. The Supreme Court, in upholding the court-martial, stated:

“The court had jurisdiction over the person and the case. It is the organism provided by law and clothed with the duty of administering justice in this class of cases. Having had such jurisdiction, its proceedings cannot be collaterally impeached for any mere error or irregularity, if there were such, committed within the sphere of its authority. Its judgments, when approved as required, rest on the same basis and are surrounded by the same considerations which give conclusiveness to the judgments of other legal tribunals, including as well the lowest as the highest, under like circumstances. The exercise of discretion, within authorized limits, cannot be assigned for error and made the subject of review by an appellate court.

“ * * * * *

“A writ of habeas corpus cannot be made to perform the functions of a writ of error. To warrant the discharge of the petitioner, the sentence under which he is held must be, not merely erroneous and voidable, but absolutely void. *Ex parte Kearney*, 7 Wheat., 38; *Ex parte Watkins*, 3 Pet., 193; *Ex parte Milligan*, 4 Wall., 2, 18 L.Ed. 281.”

Mullan v. United States, 212 U. S. 515;

Carter v. McClaughry, 183 U. S. 365.

In *Ex parte Tucker* (D.C. Mass.) 212 Fed. 569, the Court said, in following the above cited cases:

"Tucker was duly enlisted in the United States navy and was a petty officer therein. Charges of scandalous conduct tending to the destruction of good morals were preferred against him, and by order of the Secretary of the Navy a court-martial was duly convened for the trial of said charges. It is admitted by the petitioner that the court-martial was regularly organized in accordance with law and that it had jurisdiction both of Tucker and of the charges preferred against him. It found Tucker guilty and imposed a sentence of three years in prison, to be followed by dishonorable discharge and forfeiture of pay. The sentence was duly approved by the Secretary of the Navy, who designated the New Hampshire state prison, at Concord, N. H., as the place of confinement. Pending the removal of Tucker in execution of the sentence, this petition was brought.

"The only complaint which the petitioner makes against the court-martial is that, in violation of Chapter 272 of the Acts of Congress of the year 1892, the judge advocate of the court-martial was allowed to be present for a short time during a closed session of the court-martial. This is explicitly forbidden by the act referred to, and the petitioner contends that, by reason of the court-martial's disregard of the statute law, Tucker has not been properly tried, and that the sentence is illegally imposed upon him.

"It is clear that the civil courts are in no sense appellate tribunals for the revision of proceedings in courts-martial. It has been decided that in such cases the civil courts should not interfere if it appears that the court-martial had jurisdiction of the person and of the subject-matter which was tried before it, and that errors in procedure in military courts can be corrected only by the proper military authorities. In *re Grimley, Pet'r*,

137 U.S. 147, 150, 11 Sup. Ct. 54, 34 L.Ed. 636; *Ex parte Reed*, 100 U.S. 13, 23, 25, L.Ed. 538. It is true that Tucker's legal rights were disregarded by the court-martial when it allowed the judge advocate to be present, even for a short time, at the closed session; but I do not think it is the business of this court to correct the error. The statute in question relates to procedure, not to jurisdiction, and the nonobservance of it by military tribunals is a matter for the revising military authorities, not for the civil courts.

"The petition is denied, but without costs."

In *McMicking v. Schields*, 238 U. S. 99, 59 L.Ed. 1220, the Court held the denial of the accused's request for time to answer and to prepare a defense, even if contrary to Army General Order No. 58 in force in the Philippine Islands, did not warrant the petitioner's discharge on the ground that he was thereby deprived of his rights under the Philippine Organic Act due to process of law. The Court, in holding that at most it was an error of law which cannot be revised by habeas corpus, said:

"Mere errors in point of law, however serious, committed by a criminal court in the exercise of its jurisdiction over a case properly subject to its cognizance, cannot be reviewed by habeas corpus. That writ cannot be employed as a substitute for the writ of error. * * *"

In *Riddle v. Dyche*, 262 U. S. 333, in habeas corpus proceedings the prisoner claimed that his convic-

tion was illegal because the jury was made of but eleven men. The holding of the Court was that such a matter could be inquired into by appeal, not by habeas corpus.

Likewise, the Supreme Court held, in *Knewel v. Egan*, 268 U.S. 442, that it was not the function of habeas corpus to review the proceedings of a state court criminal case to determine whether or not the information was insufficient as a pleading.

The Articles of War under which the accused was tried appear in *Title 10 U.S.C.A. Secs. 1471 to 1568*. *Johnson v. Zerbst*, 304 U. S. 458 does not apply in this case because the accused was never lacking counsel. He was represented throughout the whole trial. Under the decision above, the Court will not inquire into the evidence, or how it was obtained, on habeas corpus. But, regardless of that fact, it appears from the record that no objection was pressed to the introduction of the evidence. Furthermore, it appears from the record that the search warrant was valid, based on ample evidence to show a theft under the laws of the Philippines. If competent and material evidence was obtained by means of a valid search warrant, it matters not out of what court such warrant was issued. However, it is respondent's contention that the Court need not consider nor pass upon this point.

What appears to be the last decision on this subject is *Sanford v. Robbins*, C.C.A. 5, 115 Fed. (2d) 435. In that case the Court held that the civil courts cannot review the merits of cases tried in military tribunals and that there can be no release on habeas corpus if the Court had jurisdiction to try the offender for the offense and the sentence was one which the Court could under the law pronounce. This case also states that the mere fact that the defendant may not have had counsel at a court-martial does not necessarily bring such a case within the jurisdiction of *Johnson v. Zerbst*. This case also holds that a court-martial does not lose its jurisdiction to try the accused because it ruled wrongly upon some question of law, even constitutional law.

In the case of *French v. Weeks*, 259 U. S. 335, the court said:

“Thus we have lawfully constituted military tribunals, with jurisdiction over the person and subject-matter involved unquestioned and unquestionable, and action by them within the scope of the power with which they are invested by law. It is settled beyond controversy that under such conditions decisions by military tribunals, constituted by act of Congress, cannot be reviewed or set aside by civil courts in a mandamus proceeding or otherwise.”

See also *Creary v. Weeks*, 259 U.S. 336.

CONCLUSION

The military court having jurisdiction over the person of the appellant and subject matter; the defendant at all times being represented by counsel; the conviction and sentence having been duly reviewed in accordance with the statutes of the United States and having been duly and regularly approved and confirmed by the President, the judgment of the lower court should be affirmed.

Respectfully submitted

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9
**United States Circuit Court of Appeals
for the Ninth Circuit**

No. 10242

RUFO C. ROMERO, APPELLANT,

vs.

P. J. SQUIER, WARDEN, McNEIL ISLAND, APPELLEE.

APPELLANT'S REPLY TO BRIEF OF APPELLEE.

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FILED

DEC 21 1942

PAUL P. O'BRIEN,
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United States Circuit Court of Appeals for the Ninth Circuit

No. 10242

RUFO C. ROMERO, APPELLANT,

vs.

P. J. SQUIER, WARDEN, MCNEIL ISLAND, APPELLEE.

APPELLANT'S REPLY TO BRIEF OF APPELLEE.

The Unlawful Search.

Major Evans, the Federal officer, made arrangements with the police officers to secure a search warrant and the warrant was secured on behalf of Major Evans. He accompanied and was the leader of the raiding party. He was the first person to enter the house; he searched the premises; and there and then arrested appellant and took him to Fort William McKinley together with the things he seized. The participation of Major Evans was under color of his Federal office, and the search in substance and effect was the joint operation of the local and Federal officers. In that view, the effect is the same as though he had engaged in the undertaking as one exclusively his own.

The result was that Major Evans, though not vested with police authority, executed a search warrant issued out of a justice of the peace in the Philippine Islands, and used

such warrant as the basis of Federal prosecution. Various Federal courts, including the Supreme Court of the United States, have ruled and held that a State or police warrant when executed by Federal officers may not be used as the basis of Federal search and prosecution. That would be a violation of an accused constitutional right against unlawful search and seizure guaranteed him under the Fourth Amendment to the Constitution of the United States. (*Byars v. United States*, 273 U. S. 28.)

The stipulation referred to (Tr. 156) was not a stipulation that Major Evans was competent to execute a warrant issued by a civil court of the Philippines. Furthermore, appellant has the substantial and constitutional rights of safeguards against unlawful search and seizure, and counsel cannot make stipulations which operate as a surrender of his substantial right. Nor could counsel bind his client by admission or stipulation prejudicial to the client's cause of action or defense. (2 R. C. L. 990); (*Ball v. Bank of State*, 8 Ala. 590, 42 Am. Dec. 649; *Wabash, St. L. & P. R. Co. v. McDougall*, 18 N. E. 291.)

The Entrapment.

No criminal intent originated nor existed in the mind of appellant. The prosecution's principal witness, Gepte, was the agent of Major Evans who in turn secured the services of Agbay and Cabrera. These persons agreed among themselves to frame-up appellant, with Major Evans as the master mind. The only time appellant met these persons was a day before his arrest. It must be remembered that appellant was an intelligence officer (Tr. 166), and when he was solicited by these agents of Major Evans that a certain sultan (mythical person) desired to buy maps, it was then appellant's official duty to investigate the proposition for the purpose of apprehending the supposed sultan. The act charged appellant was part of the investigation to lure

the supposed principal buyer. The fact that there was really no person buying the maps, the mythical sultan who was the supposed buyer being only a pretext devised by Major Evans and his agents to trap appellant is the best proof or conclusion that the whole scheme was entrapment.

Appellee's incorrect statement as to the record.—Appellee, in his Respondent's Notes on the Record, made an incorrect statement. The untrue statement appears on page 19 of the Transcript as follows: "Romero (R. 288) was for sometime suspected as a Japanese agent". This was called to the attention of the District Judge, and upon investigation, concurred that the statement was incorrect. Examination of the court martial record, which is page 288 as noted by appellee, nor in the entire record would disclose no such statement.

Denial of Counsel.

The record shows that appellant was denied the assistance of counsel at the preliminary investigation. He attempted to retain one Major Lynch, a retired Army officer and a practicing attorney. His presence was denied. Then appellant requested the services of one Major Poblete, a Filipino United States Army officer and an attorney of high standing. He, too, was refused by the Army investigating authorities. How can appellee's counsel now state that appellant waived the presence and assistance of counsel?

In further reply to appellee's brief on the point of assistance of counsel, appellant does not here deem it necessary to make a repetition of the facts, points of law, and authorities appearing in the Brief for Appellant, pages 9 to 13, inclusive.

The Defective Record.

Appellee seems to have the impression that if the maps were included in the record transmitted to the Review

Board the contents would be divulged to unauthorized persons by reason of the statute entitling an accused or any person authorized by him a copy of the record of trial. Article of War 35, which requires that all the original records and evidence introduced in the proceedings must be transmitted to the Judge Advocate General of the Army, calls for the inclusion of the maps. But the copy for the accused does not require the incorporation of the maps. It is only in the original record transmitted to the Review Board of the Office of the Judge Advocate General that the maps in question should have been included.

The Question of Waiver.

Appellant did not waive the right of effective representation by counsel nor the ejection of his civilian counsel in certain stages of the trial. He did not make a formal objection, it is true, but his silence did not operate as a waiver. The Manual for Courts Martial, pages 136 and 137, provides in part as follows: “* * * a waiver of an objection does not operate as a consent where consent is required, and a mere failure to object does not amount to a waiver * * *”.

As to the withdrawal of the maps at the conclusion of the trial, it is true that the trial judge advocate and the military defense counsel agreed to the withdrawal. But, in effect, they agreed to violate the act of June 4, 1920 (41 Stat. 794) and Articles of War 35 and 50½. That this agreement was of no effect and was not binding, does not require any further discussion.

The Cases Cited by Appellee Have Been Overruled.

Appellant submits his case with the knowledge that prior to the decisions in *Powell v. Alabama*, 287 U. S. 85; *Johnson v. Zerbst*, 304 U. S. 458 (decided May 23, 1938); and *Smith v. O’Grady*, 61 Sup. Ct. 572 (decided Feb. 17, 1941), it had

been universally held that habeas corpus cannot be used as a means of reviewing errors of law and irregularities occurring during the course of the trial; and the writ of habeas corpus cannot be used as a writ of error. However, much water has gone over the dam since that time; and these principles have been construed and applied so as to preserve—not destroy—constitutional safeguards of human life and liberty. The scope of inquiry in habeas corpus proceedings have been broadened. It has been definitely settled by the above last decisions of the Supreme Court of the United States that if the constitutional rights of an accused are violated, in the beginning or at any stage of the proceedings, the court loses jurisdiction.

The Supreme Court, in the *Powell v. Alabama* case, held that although an accused was in fact represented by counsel in the trial if he was not given effective aid so as to make it a fair trial, he was not represented by counsel within the meaning of the Sixth Amendment to the Constitution.

Compliance with the constitutional mandate is an essential prerequisite to a Federal court's jurisdiction. A court's jurisdiction at the beginning of a trial may be lost in the course of the proceedings due to failure to comply with the constitutional requirements.

In the present case, when appellant's constitutional right against unlawful search and seizure was violated, and further denied the assistance of counsel within the meaning of the Sixth Amendment, any proceedings thereafter was a denial of due process of law as secured by the Fifth Amendment to the Constitution, and such proceedings are void. The court martial was no longer a court of competent jurisdiction. The judgment of the court martial was absolutely void because it was rendered without authority of law and without jurisdiction. (*Byars v. United States*, 273 U. S. 28; *Powell v. Alabama*, 287 U. S. 85; *Johnson v. Zerbst*, 304 U. S. 458; *Smith v. O'Grady*, 61 Sup. Ct. 572.)

Conclusion.

The judgment of the District Court should be reversed, and a writ of habeas corpus be issued by this Honorable Court directed to the Warden, McNeil Island, Washington, and that your appellant be ordered discharged from detention and imprisonment thereat.

Respectfully submitted,

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(3540)

United States 10
Circuit Court of Appeals
For the Ninth Circuit.

SAN JOAQUIN VALLEY POULTRY PRO-
DUCERS ASSOCIATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United
States Board of Tax Appeals

FILED

OCT 9 - 1942

PAUL P. O'BRIEN,

CLERK



United States
Circuit Court of Appeals
For the Ninth Circuit.

SAN JOAQUIN VALLEY POULTRY PRO-
DUCERS ASSOCIATION,

Petitioner,

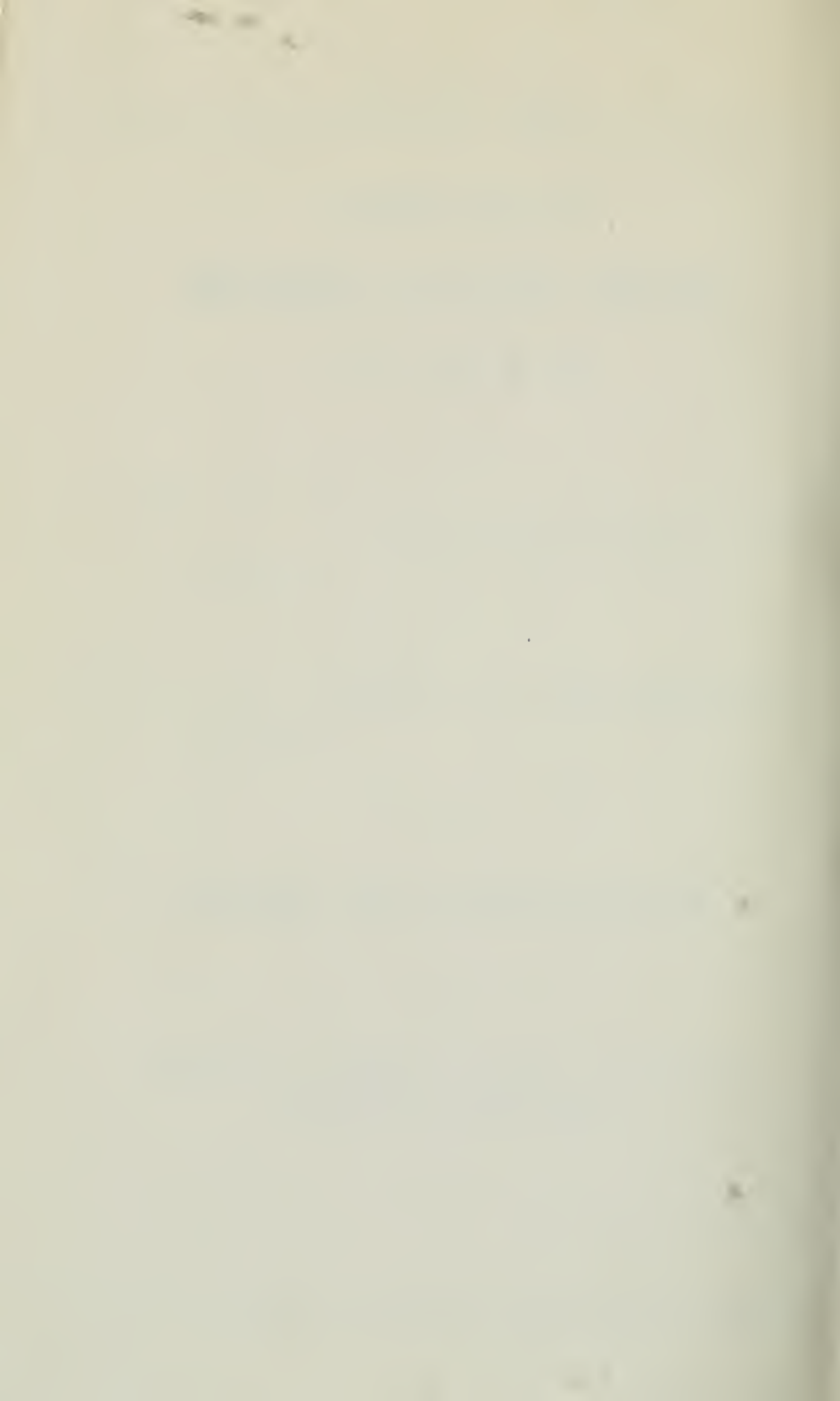
vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United
States Board of Tax Appeals



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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES:

For Taxpayer:

MILTON D. SAPIRO, Esq.

For Comm'r:

HARRY R. HORROW, Esq.

Docket No. 103408

SAN JOAQUIN VALLEY POULTRY PRO-
DUCERS ASSOCIATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1940

June 17—Petition received and filed. Taxpayer notified. Fee paid.

June 17—Copy of petition served on General Counsel.

Aug. 7—Answer filed by General Counsel.

Aug. 7—Request for hearing in San Francisco, California, filed by General Counsel.

Aug. 15—Notice issued placing proceeding on San Francisco, California, calendar. Answer and request served.

1941

April 8—Hearing set June 16, 1941, San Francisco.

1941

- June 24—Hearing had before Mr. Kern on the merits. Submitted. Briefs due Aug. 8, 1941.
Reply briefs due Sept. 8, 1941.
- July 8—Transcript of hearing June 24, 1941, filed.
- Aug. 6—Brief filed by taxpayer.
- Aug. 8—Brief filed by General Counsel.
- Aug. 8—Copy of brief served on General Counsel.
- Sept. 4—Reply brief filed by taxpayer.
- Sept. 5—Motion for leave to file brief as *Amici Curiae* and brief filed by taxpayer.
- Sept. 8—Motion for leave to file brief as *Amici Curiae* granted.
- Sept. 8—Copy of motion and brief as *Amici Curiae* served on General Counsel.

1942

- June 18—Memorandum findings of fact and opinion rendered. Kern, #16. Decision will be entered for the respondent. 6/18/42 copy served.
- June 19—Decision entered. Kern, Div. 16.
- Aug. 13—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.
- Aug. 18—Proof of service filed by taxpayer.
- Aug. 20—Agreed designation of contents of record filed. [1*]

*Page numbering appearing at top of page of original certified Transcript of Record.

United States Board of Tax Appeals

103408

SAN JOAQUIN VALLEY POULTRY PRO-
DUCERS ASSOCIATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR RE-DETERMINATION
OF DEFICIENCY

The above named petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency IRA:90-D-DCE, dated April 8, 1940, and as basis of this proceeding alleges as follows:

1. The petitioner is a non-profit, cooperative association organized and existing under and by virtue of the Agricultural Code of the State of California with its principal place of business in the City of Porterville, County of Tulare, State of California. The returns for the periods here involved were filed with the Collector for the Northern District of California.

2. That Notice of Deficiency, a copy of which is attached hereto and marked Exhibit A, was mailed to petitioner on April 8, 1940.

3. That the taxes in controversy are income taxes for the calendar years 1936 and 1937 in the following amounts: [2]

INCOME TAXES

	Deficiency
Calendar year 1936	\$2,261.01
Calendar year 1937	2,047.48
Total	<u>4,308.49</u>

4. The determination of tax set forth in the said Notice of Deficiency is based upon the following errors:

(a) The action of the Commissioner in including as income for the calendar year 1936 the amount of \$1,683.56 representing a sum set aside for Reserve for Overpayments, and which sum the Commissioner erroneously held was not deductible from gross income;

(b) The action of the Commissioner in including as income for the calendar year 1936 the amount of \$5,722.72 representing a sum set aside for Reserve for Zoning Hazard, and which sum the Commissioner erroneously held was not deductible from gross income;

(c) The action of the Commissioner in including as income for the calendar year 1936 the amount of \$2,215.29 representing a sum set aside for Reserve for Security of Membership, and which sum the Commissioner erroneously held was not deductible from gross income;

(d) The action of the Commissioner in including as income for the calendar year 1937 the amount of \$5,358.46 representing a sum set aside for Reserve for Zoning Hazard, and which sum the Commissioner erroneously held was not deductible from gross income; [3]

(e) The action of the Commissioner in including as income for the calendar year 1937 the amount of \$2,601.90 representing a sum set aside for Reserve for Security of Membership, and which sum the Commissioner erroneously held was not deductible from gross income.

5. The facts upon which the petitioner relies as a basis of these proceedings are as follows:

(a) Petitioner is a non-profit, cooperative association organized under the Agricultural Code of the State of California and engages in the marketing of eggs for its members and also engages in the sale and distribution to its members of farm supplies.

(b) In the year 1936 petitioner transacted a volume of business with non-members representing in volume 1.77% of the total volume of eggs marketed; and in 1937, representing .11% of the total volume of eggs marketed. In the purchasing division, the non-member business in 1936 represented 10.47% of the total participating patronage business done by the petitioner; and in 1937, the non-member business represented .52% of the total participating patronage business done by petitioner.

(c) The petitioner is organized without capital stock and its membership is confined entirely to producers of agricultural products. Each member pays a membership fee of Ten Dollars. The further capital for the operation of the petitioner has been derived from deductions from the proceeds of eggs marketed for the members or deductions from the net returns which otherwise would have been pay-

able to members on the basis of savings on supplies sold to them. Under the by-laws of the association, the net pro- [4] ceeds derived from overcharges on sales, after all expenses have been paid, belong to the members and are prorated in proportion to the amount of business each member has transacted with the association. In view of the limited capital funds of the association, it has been found desirable for the efficient operations of the association to retain certain of these funds, which otherwise would be distributable to members, and to place them in accounts which were entitled "Reserves". At the time these amounts were placed in such accounts, each member was credited with his respective interest in that account, and the books of the association showed at the time that the retention was made that the member was actually credited with the same so that it constituted an obligation of the association to that particular member.

(d) Under the by-laws of the association and under the accounting system as used by the association, the amounts set aside in the accounts entitled "Reserve for Overpayments", "Reserve for Zoning Hazard" and "Reserve for Security of Membership" in 1936 and 1937 as well as previous years were the property of the members and were a recognized liability of the association to the members. The members were advised of the state of their accounts and of the obligation of the association to them. No specific date for the payment of the obligation was provided, but it was contemplated

that as these amounts would increase in the various funds, so as to provide adequate protection for the operation of the association, then the earliest amounts deposited in the fund would be paid out to the members in satisfaction of the obligation of the association to them. In the event of the liqui- [5] dation of the association, these amounts were a recognized obligation to be paid before a distribution to members. These amounts did not at any time constitute net income to the association, but always represented an obligation of the association to the members.

(e) In the original report of the Examining Officer, the 1937 Reserve for Zoning Hazard which was disallowed was fixed at \$9,657.81. After conference, the amount which was not allowed as deductible was reduced to \$5,358.46. However, the entire amount should have been recognized as deductible.

(f) The Commissioner has failed to give recognition to the cooperative nature of this association and of the positive nature of the obligation represented by these reserves, and as a result has erroneously set aside their deduction from gross income and has erroneously included all of the amounts as part of the net income of the association.

(g) Petitioner has paid dividends to non-members on purchases. However, petitioner recognizes that if said dividends have not been on a similar basis to those paid to members, that it has a taxable net income based on any profit which accrues to members on such non-member business, after deducting for patronage dividends paid.

The amount of business done with non-participating members in 1936 was 13.60% of the total business; and in 1937 was 1.01% of the total business.

Therefore, the petitioner contends that the taxable net income for the years 1936 and 1937, if complete exemption [6] is not allowed, can only be calculated in the following manner:

1936			
	Total	Members	Non-Members
Percent business	100.00%	86.40%	13.60%
Net income	\$24,836.50	\$21,458.74	\$3,377.76
Patronage Distribution:			
Cash	5,420.62	2,931.44	2,489.18
Revolving Fund Certificates.....	8,794.31	8,794.31	
Revolving Fund Certificates for:			
Security of Memberships Fund..	2,215.29	2,215.29	
Retains for Zoning Hazards.....	5,722.72	5,722.72	
Retains for Overpayments	1,683.56	1,683.56	
Totals.....	23,836.50	21,347.32	2,489.18
Under distribution	1,000.00	111.42	888.58
Taxable net income for 1936.....			888.58

1937			
	Total	Members	Non-Members
Percent business	100.00%	98.99%	1.01%
Net income	\$27,563.79	\$27,285.40	\$278.49
Patronage Distribution:			
Cash	4,615.41	4,481.08	134.33
Revolving Fund Certificates.....	13,443.24	13,443.24	
Revolving Fund Credits for:			
Security of Memberships Fund..	2,601.90	2,601.90	
Retains for Zoning Hazards.....	2,292.78	2,292.78	
Totals.....	32,611.14	32,476.81	134.33
Under-Over Distribution	5,047.35	5,191.41	144.06
Taxable net income for 1937.....			144.06

[Printer's Note: Italics underlined in red in original copy.]

Wherefore, petitioner prays that this Board may hear this proceeding and determine that petitioner is not subject to tax on the amounts set aside in the Reserves for Overpayment, [7] Zoning Hazards and Security for Membership in the years 1936 and 1937; and that the taxable net income for 1936 should be calculated at an amount not in excess of \$888.58; and that the taxable net income for 1937 should be calculated at an amount not in excess of \$144.06.

MILTON D. SAPIRO

Attorney for Petitioner

2408 Russ Building

San Francisco, California

SAN JOAQUIN VALLEY

POULTRY PRODUCERS

ASSOCIATION,

[Seal] By F. M. CRABTREE

Secretary [8]

(Duly Verified) [9]

EXHIBIT A

TREASURY DEPARTMENT

Internal Revenue Service
433 Federal Office Building
San Francisco, California.

Office of
Internal Revenue
Agent in Charge
San Francisco Division
IRA :90-D-DCE
(C:T:PD-SF:GMB)

Apr 8, 1940

San Joaquin Valley Poultry Producers Association,
327 North "D" Street,
Porterville, California.

Gentlemen:

You are advised that the determination of your income tax liability for the taxable years 1936 and 1937 disclosed a deficiency of \$4,308.49 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward

it to the Internal Revenue Agent in Charge, San Francisco, California for the attention of Conference Section. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,

Commissioner,

By (Signed) F. M. HARLESS

Internal Revenue Agent in
Charge

Enclosures:

Statement

Form of Waiver [10]

STATEMENT

San Francisco

IRA:90-D

DCE

(C:TS:PD

SF:GMB)

San Joaquin Valley Poultry Producers Association,
327 North "D" Street,
Porterville, California.

Tax Liability for the Taxable Years Ended December 31, 1936 and December 31, 1937

INCOME TAX

	Liability	Assessed	Deficiency
1936	\$2,261.01	None	\$2,261.01
1937	2,047.48	None	2,047.48
	<hr/>	<hr/>	<hr/>
Totals.....	\$4,308.49	None	4,308.49
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated June 28, 1939, to your protest dated August 25, 1939, and to the statements made at the conferences held on October 17, 1939 and January 19, 1940.

A copy of this letter and statement has been mailed to your representative, Mr. Milton D. Sapiro, 2002 Russ Building, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

ADJUSTMENTS TO NET INCOME

Year: 1936

Net income as disclosed by return.....	None
Unallowable deductions and additional income:	
(a) Additions to reserves.....	\$10,621.57
	<hr/>
Net income adjusted	\$10,621.57
	<hr/> <hr/>

[11]

EXPLANATION OF ADJUSTMENTS

(a) It is held that credits to the following reserves are not deductible from gross income since they represent additions to

San Joaquin Valley Poultry Producers Association
Statement (Continued)

Explanation of Adjustments (Continued)

reserves for contingencies and not definitely determined liabilities payable by you:

Reserve for Overpayments	\$1,683.56
Reserve for Zoning Hazard.....	5,722.72
Reserve for Security of Memberships.....	2,215.29
Reserve for Legal and Auditing.....	1,000.00
<hr/>	
Total.....	\$10,621.57
<hr/>	

COMPUTATION OF TAX

Year: 1936

Excess-profits Tax:

Taxable net income \$10,621.57

Less:

10% of \$110,000.00 value of capital
stock as declared in your capital
stock tax return for year ended June
30, 1936 11,000.00

Net income subject to excess-profits Tax None

Income Tax:

Normal Tax:

Taxable net income \$10,621.57

Normal tax net income..... \$10,621.57

8% of \$2,000.00 (Over to \$ 2,000) 160.00
11% of \$8,621.57 (Over \$2,000 to \$15,000) 948.37

Total normal tax \$ 1,108.37

San Joaquin Valley Poultry Producers Association
Statement (Continued)

Computation of Tax

Year: 1936

(Continued)

Surtax on Undistributed Profits:	
Taxable net income	\$10,621.57
Less: Normal tax	1,108.37
Adjusted Undistributed net income.....	9,513.20
Less:	
Specific credit	4,048.68
Remainder subject to surtax.....	5,464.52
7% of \$ 951.32.....	66.59
12% of \$ 951.32.....	114.16
17% of 1,902.64.....	323.45
22% of 1,659.24.....	365.03
Amount of tax	\$ 869.23
Plus:	
7% of \$4,048.68 (specific credit).....	283.41
Total surtax	1,152.64
Normal tax	1,108.37
Total income tax (normal tax and surtax)	2,261.01
Income tax assessed (normal tax and surtax):	
Original list, account No. 854114—	
First California District	None
Deficiency of income tax.....	\$ 2,261.01

[13]

ADJUSTMENTS TO NET INCOME

Year: 1937

Net income as disclosed by return.....	\$ None
Unallowable deductions and	

San Joaquin Valley Poultry Producers Association
Statement (Continued)

Adjustments to Net Income

Year: 1937

(Continued)

additional income		
(a) Additions to reserves.....	\$8,335.36	
(b) Federal income tax	2,292.78	10,628.14
		<hr/>
Total		10,628.14
Nontaxable income and additional deductions		
(c) Legal and auditing expense paid	625.00	
(b) Accrued capital stock tax.....	123.00	748.00
		<hr/>
Net income adjusted.....		<u>9,880.14</u>

EXPLANATION OF ADJUSTMENTS

Year: 1937

(a) It is held that credits to the following reserves are not deductible from gross income since they represent additions to reserves for contingencies and not definitely determined liabilities payable by you:

Reserve for Zoning Hazard.....	\$ 5,358.46
Reserve for Security of Memberships.....	2,601.90
Reserve for Legal and Auditing.....	375.00

Total.....	<hr/> \$ 8,335.36
------------	-------------------

(b) Federal income tax paid is not an allowable deduction under the provisions of Section 23 (c) of the Revenue Act of 1936.

(c) Amounts paid in 1937 for legal and auditing expense and charged to the reserve established at December 31, 1936, are allowable deductions from gross income.

[14]

(d) Accrued capital stock tax is allowable as a deduction as follows:

San Joaquin Valley Poultry Producers Association
Statement (Continued)

Explanation of Adjustments

Year: 1937

(Continued)

Declared value of capital stock as at June 30, 1936	\$110,000.00
Net profit 1936, as amended.....	10,621.57
Sale of membership certificates.....	2,430.00
Adjusted declared value	<u>\$123,051.57</u>
Capital stock tax at \$1.00 per \$1,000 value	<u>123.00</u>

COMPUTATION OF TAX

Year: 1937

Excess-Profits Tax:

Taxable net income	9,880.14
Less: 10% of \$123,051.57 value of capital stock as declared in your capital stock tax return for year ended June 30, 1937	<u>12,305.16</u>

Net income subject to excess-profits tax...\$ None

Income Tax:

Normal tax:

Taxable net income.....	9,880.14
Normal tax net income.....	<u>9,880.14</u>
8% of \$2,000.00 (Over0 to \$ 2,000)	160.00
11% of \$7,880.14 (Over \$2,000 to \$15,000)	<u>866.82</u>
Total normal tax	\$ 1,026.82

[15]

Surtax on Undistributed Profits:

Taxable net income	\$ 9,880.14
Less: Normal tax	<u>1,026.82</u>
Adjusted undistributed net income.....	8,853.32

San Joaquin Valley Poultry Producers Association
Statement (Continued)

Computation of Tax
Year: 1937
(Continued)

7% of \$5,000.00.....	350.00
12% of 885.33.....	106.24
17% of 1,770.66.....	301.01
22% of 1,197.33.....	263.41
<hr/>	
Total surtax	1,020.66
Normal tax	1,026.82
<hr/>	
Total income tax (normal tax and surtax) \$	2,047.48
Income tax assessed (normal tax and surtax) :	
Original list, account No. 853871—	
First California District	None
<hr/>	
Deficiency of income tax.....	\$ 2,047.48
<hr/>	

[Endorsed]: U. S. B. T. A. Filed Jun. 17, 1940.
[16]

[Title of Board and Cause.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits that the petitioner is a cooperative association with its principal place of business in the City of Porterville, County of Tulare, State of California. The returns for the periods here in-

volved were filed with the Collector for the Northern District of California; but denies the remaining allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 or the petition.

3. Admits the allegations contained in paragraph 3 of the petition. [17]

4(a) to (e), inclusive. Denies the Commissioner erred in the determination of the deficiency as alleged in subparagraphs (a) to (e), inclusive, of paragraph 4 of the petition.

5(a). Admits that petitioner is a cooperative association and engaged in the marketing of eggs and also engages in the sale and distribution of farm supplies, but denies the remaining allegations contained in subparagraph (a) of paragraph 5 of the petition.

5(b), (c), and (d). For lack of information, denies the allegations contained in subparagraphs (b), (c), and (d) of paragraph 5 of the petition.

5(e) and (f). Denies the allegations contained in subparagraphs (e) and (f) of paragraph 5 of the petition.

5(g). Admits that petitioner has paid dividends to non-members on purchases but denies the remaining allegations contained in subparagraph (g) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's

determination be approved and the petitioner's appeal denied.

(Signed) J. P. WENCHEL

Chief Counsel,

Bureau of Internal Revenue.

Of Counsel:

ALVA C. BAIRD,

T. M. MATHER,

Special Attorneys,

Bureau of Internal Revenue.

TMM/gw

8-1-40

[Endorsed]: U. S. B. T. A. Filed Aug. 7, 1940.

[18]

[Title of Board and Cause.]

M. D. Sapiro, Esq., for the petitioner.

Harry R. Horrow, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

The respondent has determined a deficiency in petitioner's income tax for the calendar years 1936 and 1937 in the respective amounts of \$2,261.01 and \$2,047.48, which arise from his disallowance of certain deductions claimed for reserves by the petitioner which is a cooperative association engaged in marketing eggs for members and non-member poultry raisers and [19] in the sale and distribution of supplies. Three issues are raised, the first confined

to 1936, the others common to both years: (1) whether respondent erroneously disallowed \$1,683.56 as a deduction for a reserve for overpayments on egg sales; (2) deductions of \$5,722.72 and \$5,358.46, claimed for the respective years as reserves for a zoning hazard; and (3) deductions of \$2,215.29 and \$2,601.90, for the respective years, as reserves for security of membership.

The facts are as follows:

FINDINGS OF FACT

The petitioner is a cooperative association organized under the laws of California, with its principal place of business in Porterville, Tulare County. It filed its income tax returns for the years 1936 and 1937 with the collector of internal revenue for the Northern District of California.

The members of the petitioner are poultry producers. Membership is acquired by the payment of a \$10 fee, as provided in the by-laws, which, with the articles of incorporation, were put in evidence and are incorporated here by reference. Petitioner has at Porterville, California, a feed mill, warehouse, and an office for the marketing of poultry and eggs on behalf of its members. During the years 1936 and 1937 its eggs were marketed in weekly pools, and payment was made to the members participating in the pools on the basis of the number of eggs marketed by petitioner for each member, the proceeds to members being determined by the quotations in the Los Angeles market, less estimated

expenses. Petitioner [20] marketed eggs for non-members during the years 1936 and 1937, but the non-members did not participate in the pools. Eggs obtained from non-members were considered as cash purchases. During the years 1936 and 1937 petitioner sold feed and other farm supplies to members and non-members. The prices at which such supplies were sold to members were based on direct cost to petitioner, plus overhead expenses, the prices fixed being slightly above such expenses so that there would be no danger of loss to petitioner.

The following several resolutions were adopted by petitioner's board of directors on December 21, 1936:

1. One resolution authorized the payment of patronage dividends to members and non-members alike, for the year 1936, in cash or its equivalent.

2. Another resolution authorized the creation of an account on the books of petitioner designated "Reserve Against Loss by Overpayment", and recited that the aggregate amount retained from proceeds of the sale of eggs marketed by petitioner for members during the year 1936 was \$1,683.56, and that this amount was to be credited to a Reserve for Overpayments in order to avoid loss from market fluctuations, deterioration, carrying charges, or unexpected expenses in the marketing of eggs by the petitioner on behalf of its members.

3. Another resolution authorized the sum of \$5,722.72 to be transferred on the books of petitioner to an account entitled "Reserve for Zoning Hazard."

4. Still another resolution authorized the transfer of \$2,215.29 [21] to an account on the books of petitioner entitled "Reserve for Security of Membership", this amount being 10 percent of petitioner's net earnings as shown by its books for the year 1936.

5. Finally, a resolution provided for the declaration of a patronage dividend in the amount of \$14,214.93, consisting of \$11,725.75 to members and \$2,489.18 to non-members, to be paid in cash or its equivalent. This, as the resolution stated, was a dividend of 2 percent on all purchases in addition to authorized reserves to members, and a larger proportion to non-members, "equalling in percentage the amount carried to reserves for accounts of members."

The following several resolutions were adopted by the board of directors of petitioner at a meeting held on December 31, 1937:

1. One resolution recited that it was the intention of petitioner that its members should be credited on the books with their pro rata share of any amounts retained by the association which did not represent valuation reserves or other costs and expenses of petitioner, and that such credits should be paid to its members and patrons whenever its board of directors should determine that the petitioner had available funds therefor not needed for its use. The resolution authorized the accountants of petitioner to determine the amounts allocable as credits to the members, and to record such credits

on the books of petitioner, and recited that the petitioner recognized the obligation to repay such credits in the manner stated above.

2. A second resolution authorized the transfer of \$9,657.81 on the books of petitioner to an account designated "Reserve for Zoning Hazard." [22]

3. Another resolution authorized the transfer of \$2,601.90 on the books of petitioner to the account, "Reserve for Security of Membership", this amount being 10 percent of the net earnings of petitioner, as disclosed by its books for the year 1937.

4. Finally, a resolution declared a patronage dividend in the amount of \$18,058.65, consisting of a dividend to members in the amount of \$17,924.32 and a dividend to non-members in the amount of \$134.33, to be paid in cash or its equivalent before closing its books for the year 1937. This dividend was, like that in the previous year, declared on a percentage basis to members and a larger percentage to non-members.

The account designated "Reserve for Zoning Hazard" was set up to provide against a change in the zoning ordinance of the City of Porterville. The plant of petitioner was in a residential region. Since there was no zoning ordinance authorizing petitioner to operate its plant, and the adjoining land owners asserted that its noise, dust, and dirt created a nuisance, and threatened to abate it; petitioner felt that a possible change in the zoning restrictions might require its removal, with consequent expense, and so set up a reserve to meet this contingency.

The "Reserve for Security of Membership" is provided for in the by-laws of petitioner, Article VIII, section 8, which provides as follows:

There shall be reserved out of the earnings of the business of the Association each year, ten (10) per cent of the net earnings for a Reserve Fund for security of the Membership Fund; such amount shall be computed annually, deducted after all other deductions for interest, overhead and operating expenses have been made and before "Members' Purchase Credits" have been prorated. [23]

Any moneys in this Reserve Fund or in any other Fund may be invested in property belonging to the Association, in outside securities, or used as a working capital in the operation of the business, or used in the payment and retirement of the Feed Finance Fund Certificates and/or Advance Fund Certificates of the Association, or in payment of small balances standing to the credit of members in the "Members' Purchase Credits" record and in the "Members' Egg Pool Credits" record, all as provided for elsewhere in these By-Laws and all at the discretion of the Directors.

The amounts declared as patronage dividends, which were authorized by the resolutions summarized above were paid without any additional authorization of the board of directors. The resolutions declaring these dividends authorized them to be paid in cash or in interest-bearing certificates.

Article VIII, section 1, of the petitioner's by-laws provides as follows:

This Association is organized as a non-profit co-operative organization doing business with its members and with non-members as provided in the Articles of Incorporation of this Association.

The "Net Proceeds" shall be such funds as are derived from Overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the Directors.

The "Net Proceeds" resulting from the operation of the business, if any, shall belong to the members and shall be known as "Members' Purchase Credits" and shall be prorated to them in proportion to the amount of business each member has transacted with the Association during the period of time in which said "Members' Purchase Credits" have accumulated.

The Directors, after providing for all necessary overhead and all duly authorized reserves, are authorized to prorate and refund all of the rest of the "Members' Purchase Credits" to the members in proportion to each member's purchases from the Association during the time such "Members' Purchase Credits" shall have accumulated, all in the manner particularly set forth as follows:

Twenty-five (25) per cent thereof to be prorated and paid to the member in cash annually

as soon as practical after the close of business at the end of each fiscal year and after the Auditor shall have completed the annual audit and shall have re- [24] leased his report to the Directors; seventy-five (75) per cent thereof to be applied to the creation and maintenance of a "Feed Finance Fund" all as provided for elsewhere in these By-Laws.

The "Reserve for Security of Membership", which was authorized and provided for in the by-laws, was always credited before any patronage dividend was declared, for the purpose of protecting the petitioner against any loss in its working capital. No amounts credited to this reserve, pursuant to petitioner's resolution summarized above, could be paid to any member or non-member without authorization of the board of directors of petitioner.

The purpose of the resolution authorizing credits to the "Reserve Against Loss by Overpayments", was to protect the petitioner against any payments of excessive amounts to members marketing their eggs in pools. The returns from the marketing of eggs was uncertain. When the petitioner paid its members for eggs still unmarketed and at prices then quoted on the market, it ran the risk that it would not realize as much when the eggs were sold by it. Uncertainty in estimating expenses was also involved. This reserve was intended to protect the petitioner against both these risks. No amounts credited to this reserve could be paid out without authorization of the board of directors of the peti-

tioner. When any of the amounts were transferred to the reserves described above, the books showed the credits to such reserves but there was no physical segregation of cash or funds representing the amounts of these reserves. All of the moneys of petitioner were kept in one fund.

The policy of the board of directors was to authorize payment to members whenever the financial condition of petitioner was such that the [25] amounts credited to the various reserve accounts could be paid to members without any detriment to petitioner. It was understood at all times that all the moneys represented by the reserves, which were, in turn, credited to the various accounts of the members, could be used by the petitioner for any of the purposes authorized in its by-laws. But if these amounts were to be used by petitioner for payment to members in cash or interest-bearing certificates, the payment had to be authorized by the board of directors of petitioner. They could not be withdrawn by the member to whom it was credited. Sample ledger sheets taken from the books of petitioner, and put in evidence show the credits made to the accounts of the various members of petitioner, and a statement of membership equity for each member, a sample of which was put in evidence, was sent to each member at the end of each year.

Patronage dividends, when declared, were credited to the accounts of the members. The patronage dividends which were paid in cash or in certificates were kept on a separate ledger sheet. The ledger

sheet in evidence contains credits for reserves for contingent expenses, such as reserves for legal and auditing expense. The statement of membership equity is an aliquot portion of the net worth of petitioner according to its books, allocated to the individual members on the basis of patronage.

OPINION

Kern:

Petitioner is a cooperative poultry association which acts for both members and non-members. Petitioner claims the deduction of [26] three reserves set up for (1) a zoning hazard, (2) the overpayment of egg sale proceeds, and (3) for security of petitioner's membership. The first is claimed for 1936 only, the others for 1937 as well. Respondent has disallowed all three. There is apparently no claim that the amounts credited to these reserves constitute expenses, and there is no evidence that the reserves were used to meet the contingency contemplated when they were set up. Of the several reserves, that for zoning hazard would seem to be the only one which might involve a risk indeterminable in its duration and in its cost until realized. The reserves for egg sale overpayments and for certainty of membership, on the other hand, might readily have been distributed in patronage dividend payments at the end of petitioner's fiscal year, when all accounts were settled. No evidence was put in on the reasonableness of the zoning hazard reserve, the only testimony being to the effect that removal of petitioner's buildings from the residential region

where they were would cost a good deal. Since the reasonableness of this reserve has not been established, we must fall back on what appears to be, in any event, petitioner's principal reliance.

Petitioner insists in its brief that a proportionate part of all three of these reserves was allocated to each poulterer-member, was so credited on its books and so treated in the so-called "patronage" dividends distributed. The argument is, then, in effect, that the petitioner was a cooperative association under California law and the reserves constituting returns on proceeds of sales made by petitioner for its members did not belong to the petitioner and were not a part of its taxable income. It is conceded by respondent that the petitioner was a cooperative association carrying on business on a non-profit basis, and that all petitioner's earnings and assets were ultimately distributable to its members, but he contends that except to the extent that such income or assets were subject to a member's sale command during the taxable year, they must be treated as belonging to petitioner, a corporate entity distinct during its existence from its constituent members. *Fruit Growers' Supply Co.*, 21 B.T.A. 315; affirmed 56 Fed. (2d) 90 (C.C.A. 9); *Farmers' Union Coop. Co. v. Commissioner* 90 Fed. (2d) 488 (C.C.A. 8); *Coop. Oil Assn. v. Commissioner*, 115 Fed. (2d) 666 (C.C.A. 9).

In the *Fruit Growers'* case at p. 93, this point was discussed:

* * * A somewhat similar contention was con-

sidered by the Supreme Court in dealing with a mutual life insurance company. *Penn Mutual Life Ins. Co. v. Lederer*, 252 U. S. 523. It was held that, in computing the gross income of the insurance company, payments made by members could not be reduced by amounts which had not been actually repaid to them or credited to them within the taxable year. Until "patronage dividends" are declared they have not accrued as obligations from the corporation to its members. We agree in this regard with the conclusions of the Board of Tax Appeals which we quote as follows: "The petitioner now asks that we increase the patronage-dividend deduction on account of an amount which has not been returned to the members and when no dividend declaration has been made with respect thereto. We find nothing in the petitioner's by-laws which would cause these patronage dividends to accrue as such without corporate action setting them apart as a liability of the petitioner to its members. * * * [28]"

And in the *Farmers' Union* case, it was said, at p. 491:

* * * While those who might be entitled to patronage dividends have, in a sense, an interest in the money, it is a character of interest not greater, if as great, as that of a stockholder in an ordinary corporation. Such interest never ripens into an individual ownership or right of ownership until and if a patronage dividend be declared. * * *

The zoning hazard reserve we have already discussed. Obviously it could not be used by the petitioner in the emergency of a compulsory removal under new zoning restrictions if it was subject to be depleted at any time by the petitioner's patrons. The over-payment reserve was to prevent loss to the petitioner through indeterminable expenses incurred in marketing eggs and through the fluctuation in market prices between the day of the petitioner's purchase of eggs from its patrons and the day when it could resell them to the public. The membership security reserve was to avoid impairment in petitioner's working capital by a too sudden reduction in membership. It is true that the petitioner credited to its patrons on its books an aliquot part of each of these reserves, but in each case further action by its board of directors was necessary before any portion of these reserves could be made available to the members. On the other hand, patronage dividends in cash or certificates could be distributed on the authority of the resolution declaring them, without more. They were at once thereby subjected to the patron's "unfettered command" (to use the now classical phrase of Holmes, J., in *Corliss v. Bowers*, 281 U. S. 376.)

This essential difference serves to distinguish such cases as our recent *Midland Cooperative Wholesale*, 44 B.T.A. 824. We pointed out in that case that the Treasury Department, in the absence of any statutory [29] provision allowing any deduction of patronage dividends, had shown "great liberality" in allowing them at all and that the justification for

the allowance lay in the fact "that the so-called dividends are, in reality, rebates." (at p. 830). After discussing the Association's corporate structure we allowed the amounts credited to reserves and in proportion to each participating member's share on the ground that "the amounts so credited, in our opinion, could have been withdrawn by the members at any time. In at least two instances they were, in effect, withdrawn." (at p. 834).

Even a statutory deduction is a matter of legislative grace and not of right, *New Colonial Ice Co. v. Helvering*, 292 U. S. 435; and a deduction which is a matter of administrative grace necessarily rests upon even a narrower foundation. When a just and intelligible administrative line has been drawn between those reserves of a cooperative association which must be held rebates in order to satisfy substantial justice and those over which the patron-member has no control; and when that line has been upheld by this Board and the courts, we know of no way in which greater liberality can be properly accorded. See *Cooperative Oil Assn. v. Commissioner*, *supra*, at p. 668; and we, therefore, conclude that the deficiencies must be sustained.

Enter:

Judgment will be entered for the Respondent.

Entered Jun. 18, 1942. [30]

United States Board of Tax Appeals
Washington

Docket No. 103408

SAN JOAQUIN VALLEY POULTRY PRO-
DUCERS ASSOCIATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Board, as set forth in its Memorandum Findings of Fact and Opinion, entered June 18, 1942, it is Ordered and Decided: That there are deficiencies in income tax for the calendar years 1936 and 1937, in the respective amounts of \$2,261.01 and \$2,047.48.

Enter:

(Signed) JOHN W. KERN,
Member.

Entered Jun. 19, 1942. [31]

[Title of Board and Cause.]

PETITION FOR REVIEW BY THE UNITED
STATES COURT OF APPEALS FOR THE
NINTH CIRCUIT OF A DECISION OF
THE UNITED STATES BOARD OF TAX
APPEALS

The petitioner above named, by Milton D. Sapiro,
its attorney, hereby respectfully files its petition for

a review by the United States Circuit Court of Appeals for the Ninth Circuit of a decision by the United States Board of Tax Appeals rendered on the 19th day of June, 1942, determining deficiencies in the petitioner's income taxes for the calendar years 1936 and 1937 in the respective amounts of \$2,261.01 and \$2,047.48 and respectfully shows:

I.

STATEMENT OF VENUE

The petitioner, San Joaquin Valley Poultry Producers Association is a non-profit agricultural cooperative association duly organized and existing under and by virtue of the laws of the State of California with its principal place of business in Porterville, California. [32]

The returns of income tax in respect of which the aforementioned tax liabilities arose, were filed with the Collector of Internal Revenue for the first collection district of California located in San Francisco, California, and within the jurisdiction of the Circuit Court of Appeals for the Ninth Circuit. Jurisdiction of that court is founded upon Sections 1141 and 1142 of the Internal Revenue Code.

II.

NATURE OF CONTROVERSY

The controversy relates to the question as to whether the petitioner is entitled to deduct from its gross income certain amounts which had been

credited and appropriated to the individual producer members as part of their patronage returns and which then had been placed in specific reserve funds in each of the years involved.

Petitioner is an agricultural cooperative association engaged in the marketing of agricultural products of its members and the furnishing to them of supplies on a non-profit basis. It is organized without capital stock and all of its members are producers. Under its by-laws, all net proceeds resulting from the operation of its business belong to its members in proportion to the amount of business transacted with the association. Petitioner transacted a small amount of business with non-member producers but treated non-members and members alike in the payment of patronage dividends. [33]

In the course of the usual operations of such an agricultural cooperative association, there is an excess at the end of the year resulting from overcharges accumulated over estimated cost of operations. Provision is made at the end of each year so that all net proceeds are prorated in proportion to the patronage. In each of the years 1936 and 1937 this excess was determined by petitioner and was prorated among the producers in proportion to their patronage of the association.

Distribution was made to non-members in cash. Distribution to members was made in three ways: (1) part was distributed in cash; (2) part was credited and appropriated to the individual mem-

bers and then placed in certain existing capital funds and the interest of the individual was evidenced by a certificate issued to him; and (3) part was credited and appropriated to the individual members and then placed in certain reserve funds set up under the direction of the by-laws or the Board of Directors and the interest of the individual in such funds was evidenced by a statement sent to him. The amounts involved in this latter distribution referred to as (3) are the sums in question in this proceeding.

Specific amounts were appropriated for each fund by order of the Board of Directors. These funds were placed to the credit of the individual producer and were recognized as a liability of the association to the individual producer member by action of the Board of Directors. A statement was given to the individual producer as to the extent of his interest in each of said funds. This use of the funds otherwise payable [34] to the individual was all with the approval of the individual members. This practice of so handling these refunds was explained to each producer when he became a member.

In 1936 a deduction was made from the returns otherwise due to producer for a reserve for overpayments on eggs sold. Also in 1936 a deduction was made for a reserve for a zoning hazard created by the Board of Directors and a reserve for security of membership provided for in the by-laws.

In 1937 deductions were made for the reserve for zoning hazard and the reserve for security of mem-

bership. In each instance the specific amount placed in such reserve was appropriated for and credited to the individual member producer by action of the Board of Directors, and a statement of his interest in these funds forwarded to him.

The Commissioner refused to allow these deductions from gross income and assessed a deficiency tax against petitioner for each of said years. The United States Board of Tax Appeals sustained the deficiency on the ground that such deductions could only be allowed if they were such as could be withdrawn at any time by the producer and so as it said "be subject to his sole command." Petitioner contends that the Commissioner and the Board of Tax Appeals have completely disregarded the fact that a definite liability to the producer member existed; that a definite credit had been set up for the producer; and that the allocation of that part of the patronage refund to these respective reserve funds is by and with the assent and direction of the producer. [35]

Petitioner further contends that the fact that payment might be deferred does not change the nature of these refunds as being originally the property of the producer member. Petitioner contends that inasmuch as there had been a definite act of appropriation to the credit of the producer and the liability to the producer had been definitely created, such amounts were deductible from gross income and were not a part of taxable income. Also petitioner contends that it was entitled to establish

reasonable reserves and the amounts placed therein did not constitute net income.

III.

ASSIGNMENTS OF ERROR AND STATEMENT OF POINTS UPON WHICH THE PETITIONER INTENDS TO RELY

Petitioner assigns as errors the following acts and omissions of the Board of Tax Appeals:

(1) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of \$1,683.56 which was deducted and placed in a reserve for over-payment on eggs sale.

(2) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of \$5,722.72 which was deducted and placed in a reserve for zoning hazard.

(3) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of \$2,215.29 which was deducted and placed in a reserve for security of membership.

(4) The failure to allow as a deduction from petitioner's gross income in 1937 the sum of \$5,358.46 which was deducted and placed in a reserve for zoning hazard. [36]

(5) The failure to allow as a deduction from petitioner's gross income in 1937 the sum of \$2,601.90 which was deducted and placed in a reserve for security of membership.

(6) The failure to find that the deductions made for each of said reserve funds in the years 1936

and 1937 constituted an actual liability between petitioner and the individual producer members in proportion to their patronage and in the amounts respectively credited to each of said members in said reserve funds.

(7) The failure to find that the amounts credited in each of said reserve funds for the years 1936 and 1937 had been appropriated to the individual producers in proportion to their patronage and transferred to said funds as an addition to the working capital of the association with the assent of the said producers.

(8) The failure to find that the items disallowed were accrued as obligations of the association to the individual members.

(9) The failure to find that there was an existing liability of petitioner to each of the members in the specific amounts credited to each member in said reserve funds.

(10) The failure to find that the funds placed in these specific reserves in the respective years were credited to the individual members in proportion to their patronage and belonged to such members.

(11) The holding that there was required further corporate action by the Board of Directors of petitioner before [37] the amounts placed in such funds belonged to said producers.

(12) The failure to find that the amounts placed in said funds constituted a liability of said petitioner to each of said producers and that the liability

was created by the Board of Directors when the distribution to said funds was authorized.

(13) The failure to find that no further action of the Board of Directors was required for the purpose of creating said liability.

(14) The holding that the only deductions allowed would be limited to the amounts payable on the demand of the producers.

(15) The failure to find that the amounts placed in the (a) reserve against loss by over-payment for eggs in 1936, (b) the reserves for zoning hazard and security of membership in the years 1936 and 1937, respectively, did not constitute net income of the petitioner.

(16) The failure to find that petitioner was entitled to establish such reserves and place the respective amounts therein in the years 1936 and 1937 as a non-profit cooperative agricultural association.

(17) The failure to find that the reserves so established were reasonable reserves.

(18) The finding and holding that there were deficiencies in income tax for the calendar years of 1936 and 1937 in the respective amounts of \$2,261.01 and \$2,047.48 due from petitioner.

MILTON D. SAPIRO,

Attorney for Petitioner,
1411 Mills Tower, San
Francisco. [38]

(Duly verified.)

[Endorsed]: U. S. B. T. A. Filed Aug. 13,
1942. [39]

TESTIMONY

[Title of Board and Cause.]

Post Office Building,
San Francisco, California

June 24, 1941, 3:30 p. m.

Before: Hon. John W. Kern.

Met pursuant to notice.

Appearances:

Milton D. Sapiro, Mills Building, San Francisco, California, appearing for the San Joaquin Valley Poultry Producers Association, the petitioner.

Harry R. Horrow, appearing on behalf of the Commissioner of Internal Revenue, the respondent. [41]

PROCEEDINGS

The Member: San Joaquin Poultry Producers Association, Docket No. 103408.

Mr. Sapiro: Ready.

Mr. Horrow: Ready, your Honor.

The Member: Will counsel please state their appearances for the record?

Mr. Sapiro: Milton D. Sapiro, counsel for petitioner.

Mr. Horrow: Harry R. Horrow, for respondent.

The Member: May I have a statement as to the issues involved?

STATEMENT OF CASE ON BEHALF OF
PETITIONER

Mr. Sapiro: If your Honor please, the petitioner, San Joaquin Valley Poultry Producers Association, is a non-profit cooperative agricultural association organized under the Cooperative Agricultural Act of the State of California. That Act was originally Title 23 of the Civil Code of the State of California, but is now a division of Section 6 of the Agricultural Code, being Sections 1191 and the following sections of that Code.

That is, in 1933 many of the statutes in reference to agriculture were codified and this Cooperative Marketing Act, as it was known, was placed in that statute.

The petitioner operates in the San Joaquin Valley. It is organized without capital stock. Its membership is [43] composed entirely of persons engaged in the production of poultry. It markets the poultry products of its members, principally eggs, and also furnishes the members with supplies used in the production of these products, principally feed. The eggs are marketed on a non-profit basis in weekly pools, and their weekly return is made to the producers; and if at the end of the year there were any excess of the weekly return that was made, that would have been returned to the producers on the basis of the quantity of eggs marketed.

It happens that in the operation they pay such close margins that there is not that excess ordinarily.

The process of supplying them with supplies is

based on the usual cooperative practice whereby a slight overcharge is made over the cost and the estimated expenses of handling for the purpose of assuring that they will recover the amount that has been expended to secure those supplies for the producers.

Then at the end of the year the excess, as it is determined, is prorated among the various producers in proportion to their patronage with the Association.

The Association, not being a capital stock organization, has secured funds for its capital needs in a manner that has been very common among our California group of cooperatives particularly, what we call a sort of revolving fund [44] feature. That is, recognizing the situation of farmers, the Association acquires capital gradually by deducting either from the proceeds of sale of products or from the overcharges as they do on the furnishing of supplies a certain percentage for amount that it credits to the producer and for which it is obligated and has a liability to the producer just as any other loan obligation would be, but which it is not obligated to pay back immediately, but at some future date when sufficient sums have been accumulated; and then the further sums that are realized or accumulated are used to pay off those from whom the money was first retained.

That system enables the Association then to be carried on by those who are actively engaged in using its services. They supply the capital funds, and by reason of the slow process of revolving

places the Association in a position where it will have the use of that fund for a period, and no great amount will be drawn out at any one particular time so as to disrupt and make impossible the continuance of its operations.

This Association is operated in that manner, and there are two years of operation involved in this particular proceeding.

I might state, incidentally, that the Association did deal with non-members, but in a very limited way. As a [45] matter of fact, in the year 1936 in the marketing of eggs the quantity marketed for non-members as compared with that which was marketed for members was approximately a little over one per cent. In the year 1937 the quantity so marketed was approximately 1-10th of one per cent in volume of eggs.

In the matter of supplying of feed and other supplies, in 1936 the percentage of non-members' business was approximately 10 per cent, but in 1937 the non-membership business was approximately 1.06 per cent. That is, the tendency of the Association has all along been to eliminate non-member business.

Incidentally, they have paid patronage dividends to the non-members, as we will show from the records and from the resolutions of the Board of Directors. But in 1936 and 1937—these are the main issues involved in this particular proceeding, and the one as to whether or not this Association isn't entirely exempt by its compliance with the provisions of the Revenue Acts.

As I say, in those two years there were deductions made from the gains which would have otherwise been paid to the producer members, which were placed in three funds in 1936 and in two of the same funds in 1937.

These deductions of funds were called on the records "Reserves". They were really "retains" or were for that [46] purpose, and it was for overpayment of eggs and was a refund recreated to protect the Association or to enable it to have funds in event that it over paid its members on eggs in any particular season.

The other fund was a fund of a reserve for zoning hazard.

There was a situation in connection with the building occupied by the Association where it was felt that it might be necessary to either make improvements on there to eliminate noise and dust or to move. And they wanted to build up a fund to do this.

A third fund or reserve, as it was entitled, was provided for in the bylaws and it was called a "Reserve for Security of Membership" and is a 10 per cent deduction of the matter of gains made from overcharges provided for in the bylaws for the purpose of gradually building up capital.

In 1937 there were deductions for two of those reserves only, the Reserve for Zoning Hazard, and the Reserve for Security of Members, as they were entitled.

The Association at the time it made those deductions apportioned the amounts among the members

in accordance to their patronage and the amount of their patronage, credited those amounts on the books of the Association. And they were under the contention of the petitioner an [47] obligation of the Association. We contend that there was a distinct appropriation of those amounts, that they should have been recognized as proper deductions, that they were no longer the property of the Association and that they did not constitute in any manner a profit or gain to the Association.

That is the basis of the proceeding before the Board here today.

The Member: Thank you. Mr. Horrow?

Mr. Horrow: As I understand it, there is no controversy here as to whether or not the taxpayer is a taxable cooperative?

Mr. Sapiro: Well, I believe that there is. I think that the record will show that it is not a taxable cooperative.

Mr. Horrow: If your Honor please, I am unable to find anything in the pleadings that alleges that the petitioner is exempt from taxation by reason of any provision of the Revenue Act, nor are there any allegations to support a claim for exemption. That is a matter that I——

Mr. Sapiro: We allege the non-profit nature of the petitioner under the Revenue Act. You have denied that particular phase, and I think that that places it in issue.

Mr. Horrow: If your Honor will examine the assignments of error in this petition I think that it will soon [48] be apparent that there is no conten-

tion whatever here as to whether or not the petitioner is exempt from taxation. The sole controversy here, as I understand it, is whether or not the taxable income computed by the Respondent is correct for the years in question.

Mr. Sapiro: Well, I suppose that is implicit in both.

Mr. Horrow: I can say, your Honor, that the issue as to whether or not they are tax exempt has never been raised before the Bureau or before the Technical Staff.

The Member: Just from a cursory reading of this Assignment of Errors I don't think that that issue is properly raised in the pleadings. The errors assigned "(a)", "(b)", "(c)", "(d)" and "(e)" refer to various reserves that are in there.

Mr. Sapiro: That is correct.

The Member: And there is recited as one of the paragraphs of facts that petitioner is a non-profit cooperative association organized under the Agricultural Code of the State of California. But I would not consider that that was an assignment of error. That is no way to raise an issue of that kind, to hide it under the allegations of fact.

Mr. Sapiro: No. Of course, I have no desire to hide issues. [49]

The Member: I mean, it does not raise the issue as far as this proceeding is concerned.

Mr. Horrow: Well, I can say that I have no objection to proceeding in the trial of that issue if we were prepared on it, but we never had that issue presented to us, and I don't know what the facts are pertaining to it.

Mr. Sapiro: Well, I think that all of the facts will have to be developed as to the conduct of the Association.

Mr. Horrow: I will object to any trial on that particular issue, and at the proper time I will object to any evidence on that particular issue. My understanding is that the issues related to the deductibility of certain so-called "reserves". The respondent held that these were reserves for contingencies.

The Member: Well, the petition indicates that. There are five allegations of error, three with regard to reserves one year, and two with regard to reserves for another.

Mr. Sapiro: That is correct, your Honor. And of course, it is improper to disallow those on a non-profit marketing association. I don't think you will be at any disadvantage if we present the facts.

STATEMENT OF CASE ON BEHALF OF RESPONDENT

Mr. Horrow: Continuing with the statement of the [50] issues, the respondent considered that the amounts represented by these reserves were still a part of the property of the petitioner; that the credits that were made on the books of the petitioner to the various members were simply bookkeeping entries, and that the amounts represented by the reserves were no different from any other assets which the petitioner possessed.

So that our position is, in effect, that there can

be no accrual for the amounts that are covered by these so-called "Reserves".

Mr. Sapiro: Shall we proceed, your Honor?

The Member: Yes, proceed. Call your first witness.

Mr. Sapiro: Mr. Roby.

MR. W. B. ROBY

a witness called on behalf of the petitioner, being duly sworn, testified as follows:

The Clerk: State your full name, please?

The Witness: William B. Roby; R-o-b-y.

Direct Examination

Q. (By Mr. Sapiro) What is your address, Mr. Roby? A. Porterville, California.

Q. And you are the General Manager of the San Joaquin Valley Poultry Producers Association?

A. Yes, sir. [51]

Q. And how long have you been such?

A. Since nineteen—since the Association was organized under that name and prior to that under the old name. Since it was first organized.

Q. It was formerly known as the Porterville Poultry Association? A. Right.

Q. Since 1925? A. That is correct.

Mr. Sapiro: I might say, your Honor, that with the request of counsel we are permitted to put in a printed set of the articles and bylaws of the Association as they exist.

Q. (By Mr. Sapiro) Showing you a printed copy of Articles and Bylaws of San Joaquin Valley

(Testimony of W. B. Roby.)

Poultry Producers Association, can you state whether or not that is the Articles and Bylaws as they existed in 1936? A. It is.

Mr. Sapiro: We would like to offer that in evidence as Petitioner's Exhibit No. 1.

The Member: Admitted in evidence.

(The copy of articles and bylaws so offered and received in evidence, was marked Petitioner's Exhibit No. 1 and was made a part of this record.) [52]

Q. (By Mr. Sapiro) I am showing you a printed set of the Articles and Bylaws as amended February 4, 1937. Is that the Articles and Bylaws as they existed in 1937? A. Yes.

Mr. Sapiro: For the information of your Honor I wish to say that the amendment appears on page 21 and merely refers to the manner of election of directors and the other elements of the bylaws are the same.

The Member: Do you offer that in evidence?

Mr. Sapiro: I offer that in evidence.

Mr. Horrow: No objection.

The Member: Admitted in evidence.

The Clerk: Two.

(The articles and bylaws as amended so offered and received in evidence, were marked Petitioner's Exhibit No. 2 and were made a part of this record.)

(Testimony of W. B. Roby.)

Q. (By Mr. Sapiro) You are familiar with the members of the Association, are you not?

A. Yes, sir.

Q. What is their occupation?

A. Poultry producers.

Q. All of them?

A. Yes. They may be other—they may be producers of other agricultural products, but they are all producers of poultry. [53]

Q. They are all farmers?

A. All farmers.

Q. And on entering the Association they pay a membership fee of \$10 as provided by the by-laws?

A. Yes, sir.

Q. Where is the principal place of business?

A. Porterville, California.

Q. And you have a plant there?

A. Yes, sir.

Q. And of what does that plant consist? Feed mill?

A. Feed mill and warehouses.

Q. And a selling office, I presume?

A. Yes, sir.

Q. And you market poultry of your members?

A. At the present time we do not.

Q. Do you market the eggs? A. Yes, sir.

Q. In 1936 what did you market?

A. We marketed a small amount of poultry, but principally eggs; very little poultry then.

Q. On what basis were those eggs marketed?

A. In Los Angeles.

(Testimony of W. B. Roby.)

Q. No. On what basis? How were they handled?
In pools? A. Yes; weekly pool.

Q. A weekly pool. And how did you make your payment to [54] the producers?

A. By Association check at the end of each week.

Q. And how was it determined? What amount?

A. Determined upon the basis of the number of eggs each member marketed or delivered to us to market, and the price was determined by the Los Angeles quotations less expenses.

Q. Less estimated expenses?

A. The price we received in Los Angeles, which was based on the market quotations less our expenses.

Q. And those proceeds were returned on that basis? A. Yes, sir.

Q. And then during 1937 you also marketed eggs for your members? A. Yes, sir.

Q. And returned them the same basis?

A. Yes, sir.

Q. Did you market some eggs for non-members during 1936? A. A very small amount.

Q. Do you know how payment was made and what payment was made to the non-members?

A. The non-members did not participate in the pool. They were entered in our records and considered as cash purchases.

Q. And were those cash purchases made at the market?

(Testimony of W. B. Roby.)

A. Very nearly the same as to members. [55]

Q. Was there any gain made off of those purchases?

Mr. Horrow: Objection to that upon the ground it calls for a conclusion, and the books and records are the best evidence.

What is your purpose here?

Mr. Sapiro: I might say that in dealing with non-members on eggs I don't want——

Mr. Horrow (Interposing): And that goes to the issue of tax exemption. I will object upon the ground that it is not a part of any issue in this case, your Honor.

Mr. Sapiro: Oh, no, it is a source of gain.

The Member: Well, you have stated two good objections anyway. I will sustain the objection on the grounds stated.

Q. (By Mr. Sapiro) In 1937 you dealt with non-members on eggs, did you not?

A. Yes, sir.

Q. And just handled a small quantity?

A. Very small.

Q. The feed and other agricultural supplies were sold by the Association to members and non-members who were producers? A. Yes, sir.

Q. The non-members were producers as well as the members? A. Yes, sir. [56]

Q. And in 1936 feed and supplies were sold?

A. Yes sir.

Q. On what basis were the feed and supplies sold? A. You mean basis of price?

(Testimony of W. B. Roby.)

Q. Yes. How was the——

A. (interposing) They were sold to the member on the basis of what the cost is to the Association, plus the cost of mixing, delivering and selling, including office. The price fixed is intended to be slightly above that cost and expense, so that at the end of the year there will be no danger of a loss.

Q. Then at the end of the year the excess overcharge, if any, is distributed as provided——

A. (interposing) It is prorated to the members in proportion to the patronage.

Q. In 1936 did you deal with non-members in the Supply Department?

A. In a small way we did.

Q. Were any funds prorated to them at the end of the year? A. Yes, sir. There——

Mr. Horrow (interposing): Just a moment! In speaking of proration are you referring to entries made on the books of petitioner, Mr. Roby?

The Witness: Well, I am trying to answer the question as it was asked, which is what we did. And—— [57]

Mr. Horrow (interposing): What does the word "Proration" mean to you? Does that mean "entries on the books" of petitioner?

The Witness: That's the way it would be represented.

Mr. Horrow: I will object, your Honor, upon the ground that the records of petitioner are the best evidence. I move that the witness's statement be stricken.

(Testimony of W. B. Roby.)

The Member: Well, he can testify to the fact that there were prorations. And I think he has already testified to that.

Mr. Horrow: I have no objection to testimony as to method.

The Member: All right. Overruled.

Q. (By Mr. Sapiro) Had you answered the question, Mr. Roby? A. Yes, sir.

Q. Then in 1937 was the same procedure followed as to feed? A. Yes, sir.

Q. Mr. Roby, what is that book?

A. This is the minutes book in which the record of the minutes is kept by the directors.

Q. The minutes of the Board of Directors?

A. Yes, sir.

Q. And you have examined those minutes?

A. Yes, sir.

Q. And you are familiar with the same? [58]

A. Yes, sir.

Q. You were present at the meeting?

A. Yes, sir.

Q. This book is the minutes book up to and including February 20, 1937? A. Yes, sir.

Q. And this other book that is marked "Minutes" is a continuation of the same?

A. A continuation of that record.

Mr. Sapiro: We might save time if I offered some individual resolutions that appear in these minutes, unless you want the witness to read them.

Mr. Horrow: Your Honor, I can't see the relevancy of this particular resolution that has been

(Testimony of W. B. Roby.)

shown to me to the issues in this case. It may be relevant on the question of tax exemption, but my understanding of the issues is that that is not involved in this case, and it is not relevant of the question of reserves.

Mr. Sapiro: It is relevant in this way, your Honor. It is our contention (and the allegations of the petition bear it out) that under the bylaws of this Association the net proceeds belong to the members, and also that it operates on a non-profit basis. There is some question in the cases as to whether there must be some act on the part of the Board of Directors appropriating the proceeds for [59] the purpose of establishing the fact that the credit has been duly entered.

The resolutions which we have here refer to that situation. They show two things:

1. That the non-profit operation by reason of the fact that members and non-members were to be treated alike, and

2. They show the actual appropriations.

That is, there are a series of resolutions providing for the fixing of the proration and the setting up of these funds which were provided for by action of the Board of Directors.

The Member: Well, it may be that with regard to those other issues it might conceivably be relevant. I agree with Mr. Horrow, however, that the only issues properly presented in this proceedings by the pleadings are those with regard to the re-

(Testimony of W. B. Roby.)

serves. And while I will overrule this objection I don't want counsel to understand that I consider that that other issue is before me.

Mr. Sapiro: I understand that very clearly, your Honor, and I advised counsel that I was offering them for the purpose of establishing the propriety of our claim as to the deduction for reserve.

The Member: All right. You don't object to these copies? [60]

Mr. Horrow: No, your Honor. I have no objection except that——

The Member (interposing): You just want to raise that point.

Mr. Horrow: I want to raise that point and make it clear that I am not conceding that the issue of tax exemption is in this case.

The Member: All right.

Mr. Sapiro: I understand that very clearly.

The Member: All right. The objection is overruled.

Mr. Sapiro: The first resolution from the meeting of December 21, 1936 is entitled "Patronage Dividend to Members and Non-members Alike".

The Member: It will be admitted in evidence.

The Clerk: Three.

(The copy of resolution so offered and received in evidence, was marked Petitioner's Exhibit No. 3 and was made a part of this record.)

Mr. Sapiro: The next resolutions are from the meeting of December 31, 1936, the resolution in

(Testimony of W. B. Roby.)

reference to setting up the reserve for loss by overpayment for eggs.

Mr. Horrow: No objection, your Honor.

The Member: It will be admitted in evidence.

The Clerk: Four.

(The resolutions of Dec. 31, 1936 [61] so offered and received in evidence, were marked Petitioner's Exhibit 4, and were made a part of this record.)

Mr. Sapiro: A resolution in reference to the patronage dividend.

The Member: Admitted in evidence.

The Clerk: Five.

(The resolution of patronage dividend so offered and received in evidence, was marked Petitioner's Exhibit 5, and was made a part of this record.)

Mr. Sapiro: And the resolution in reference to the setting up of Reserve for Zoning Hazard.

Mr. Horrow: No objection, your Honor.

The Member: It will be admitted in evidence.

The Clerk: Six.

(The Reserve for Zoning Hazard resolution so offered and received in evidence, was marked Petitioner's Exhibit 6, and was made a part of this record.)

Mr. Sapiro: And the resolution for Reserve for Security of Membership Fund.

Mr. Horrow: No objection.

The Member: It will be admitted in evidence.

(Testimony of W. B. Roby.)

The Clerk: Seven.

(The resolution for Reserve for Security of Membership Fund so offered and received in evidence, [62] was marked Petitioner's Exhibit No. 7, and was made a part of this record.)

Mr. Sapiro: From the minutes of the meeting of December 31, 1937 I would like to offer the resolution in reference to the establishing of credits in these funds.

The Member: Admitted in evidence.

The Clerk: Eight.

(The resolution re establishing of credits so offered and received in evidence, was marked Petitioner's Exhibit No. 8, and was made a part of this record.)

Mr. Sapiro: I would like to offer the resolution entitled "Security of Membership Fund".

The Member: Admitted in evidence.

Mr. Horrow: No objection.

The Clerk: Nine.

(The Security of Membership Fund Resolution so offered and received in evidence, was marked Petitioner's Exhibit No. 9, and was made a part of this record.)

Mr. Sapiro: Resolution entitled "Patronage Dividend".

The Member: Admitted in evidence.

The Clerk: Ten.

(The Patronage Dividend resolution so offered and received in evidence, was marked

(Testimony of W. B. Roby.)

Petitioner's Exhibit No. 10, and was made a part of this record.)

Mr. Sapiro: And resolution setting up the Reserve for [63] Zoning Hazard.

The Member: Admitted in evidence.

The Clerk: Eleven.

(The Reserve for Zoning Hazard Resolution, so offered and received in evidence, was marked Petitioner's Exhibit 11, and was made a part of this record.)

Mr. Sapiro: May it be stipulated that copies may be accepted in place of the originals, Mr. Horrow?

Mr. Horrow: As I understand it, the copies are in evidence.

The Member: They are in evidence.

Q. (By Mr. Sapiro) Mr. Roby, you are familiar with the resolutions that were adopted by the Board of Directors? A. Yes, sir.

Q. And as General Manager did you furnish to the Board the figures embodied in the resolutions which have been introduced?

A. Yes, sir.

Q. In the resolution marked "Exhibit 10" with reference to 1937, showing you that resolution as to patronage dividend, I note that there is a different rate of dividend provided for non-members and members. Will you state what the rate of dividend was?

Mr. Horrow: What does that go to, Mr. Sapiro? Does this go to the question of tax exemption?

(Testimony of W. B. Roby.)

Mr. Sapiro: No. This goes to the question of the [64] non-profit operation.

Mr. Horrow: I submit, your Honor, that there is nothing relating to that that bears on the issue of the deductibility of these amounts for reserves.

The Member: Sustained.

Mr. Sapiro: Does your Honor sustain that?

The Member: I sustained the objection.

Q. (By Mr. Sapiro) Mr. Roby, were the resolutions referred to creating the various funds—was the Security for Membership Fund created in the Association?

A. It was provided for in the bylaws.

Q. And was it carried on the books of the Association?

Mr. Horrow: I will ask that the books and records be submitted. The witness is not qualified to testify about the books, your Honor. The books are the best evidence.

The Member: I assume so, but that is a technical objection. It is not very often raised.

Are the books and records here, Mr. Witness?

The Witness: Yes.

Mr. Horrow: There is no dispute as to the figures, your Honor.

Mr. Sapiro: We have the accountant here. We don't have the original books. We have had him bring ledger pages. I talked with Mr. Horrow and told him we would have him bring these two weeks ago, and told him we would [64A] have him bring

(Testimony of W. B. Roby.)

the sample of ledger pages of individual producers showing the entries which we have.

Mr. Horrow: Yes. I am agreeable to his using copies or transcripts of the records, but as I understand it there is no dispute about the amounts at all.

Mr. Sapiro: No. There is no dispute about the amounts. The question wasn't directed to the question of amount. I asked him were those funds created. A. Yes.

Q. (By Mr. Sapiro) Would you state the circumstances under which the Reserve for Zoning Hazard was set up?

A. The plant of the Association was adjoined on the one side by residence property in which two different families resided. There being no zoning ordinance in the city giving us authority to operate there or forbidding us to operate there, they raised the question that the noise and dust and dirt created a nuisance and they threatened to have our operations stopped because of that nuisance. And the zoning hazard fund was set up because the directors felt that something would have to be done to meet this objection. They didn't know at the time exactly what would be the best way to meet it, but they were convinced that something would have to be done which would probably cost considerable money and be an expense that would be necessary to allow us to keep in operation. [65]

Q. Where were the funds obtained that constituted that fund?

(Testimony of W. B. Roby.)

A. Came from the overcharges to members.

Q. And when the deduction was made were the members credited with the deductions?

A. Yes, sir.

Q. And was that done in the year 1936? Were they credited for the deductions in the year 1936 of that year?

A. Well, I'm not—from memory I am not in a position to say just exactly when the setup was made.

Q. I mean, were those deductions that were made out of the net overcharges in 1936 credited on the books?

A. Yes, sir.

Q. To the individual members?

A. Yes, sir, I think they were at that time.

Q. Now, was that true also in 1937?

A. Yes, sir.

Q. Now, the fund for security of membership is provided for by the bylaws?

A. Yes, sir.

Q. And when those deductions are made are they credited to members?

A. Yes, sir.

Q. On the books?

A. Yes, sir.

Q. Mr. Roby, examining that form letter will you state what [66] that is?

A. That's a letter of information we send to all new members when they are accepted by the Board of Directors.

Q. That is sent to them with their membership certificate and one of these printed copies of the bylaws and the articles of incorporation?

A. Yes, sir.

(Testimony of W. B. Roby.)

Q. And that was sent in 1936 and 1937?

A. Yes, sir.

Mr. Sapiro: We would like to offer in evidence as petitioner's exhibit next in number this letter, and state that we believe this refers to the reserves and as to the nature of the member's interests as a binding obligation on the part of the Association in its interpretation of its agreements.

Mr. Horrow: Your Honor, I think the letter on its face simply shows that it is a letter of transmittal and attempts to summarize the benefits accruing under the bylaws and under the membership certificates. And I will object upon the ground that it has not been shown to be relevant of material to any of the issues in this case.

The Member: Objection overruled.

Mr. Horrow: Exception, please.

The Clerk: Twelve.

(The letter so offered and [67] received in evidence, was marked Petitioner's Exhibit No. 12, and was made a part of this record.)

Q. (By Mr. Sapiro) Mr. Roby, the Association does not pay any interest on its membership certificates, does it? A. No sir.

Mr. Sapiro: That is all, Mr. Horrow.

Cross Examination

Q. (By Mr. Horrow) Mr. Roby, you stated that the fund for Reserve for Zoning Hazard was set up. You did not mean to state that an amount of cash was set aside representing the amount in that reserve, did you?

(Testimony of W. B. Roby.)

A. The amount that was shown in that resolution was set up in our records, was set up as a fund which could be used for the purpose of covering any expense that might come because of that hazard.

Q. As a matter of fact, the moneys in the reserve or represented by the reserve were invested in assets of the petitioner, isn't that correct?

A. All of the moneys in the Association, as far as being separated in its use is concerned, were in one fund. They were in one bank account.

Q. So that there was no separation of any amount for this so-called Reserve for Zoning Hazard? [68]

A. The separation as to the use of the money was made and was set up, and the purpose for which it could be used was authorized.

Q. Now, what was the purpose for which it could be used?

A. It could be used to cover any expense that might accrue because of the hazard due to the complaint of a nuisance.

Q. You mean for the purpose of paying any expense that might be incurred in the future by the petitioner as a result of the change in the zoning?

A. Any expense that might accrue to the Association because of anything they might have to do to alleviate that nuisance.

Q. Was it intended that any amount represented by this reserve be paid to any member or any non-member?

(Testimony of W. B. Roby.)

A. If it wasn't used for the purpose that it was intended in the resolution and set up in the records it belonged to the members and would have to go to the members the same as every other fund, and they would have their interest in it no matter what it was used for, the same as every other fund.

Q. Would that be determined by action on the part of the Board of Directors, the subsequent payment of the amount represented by that reserve?

Mr. Sapiro: I don't quite follow that. What do you mean by that? You mean the type of payment or time of payment? [69]

Mr. Horrow: I will reframe my question.

Q. (By Mr. Horrow) Was it understood that the amount of reserve for zoning hazard would not be paid to any member or non-member of petitioner except upon action of the Board of Directors?

A. No money was ever paid to the members without authorization of the Board.

Q. Referring to the resolutions relating to the Patronage Dividend, calling your attention to Petitioner's Exhibits 5 and 10, were the amounts of those patronage dividends paid after the resolutions which are covered by those exhibits were adopted?

A. The portion—I would have to read this through to be sure I had answered correctly. I can state in a general way, however, that the dividends that were authorized by the Board of Directors were also paid as directed. If it was a cash dividend it was paid in cash, and if it was a dividend

(Testimony of W. B. Roby.)

for which certificates were issued, a certificate was issued according to their direction.

Q. Was any further act of the Board of Directors necessary before the amount of the patronage dividends covered by these resolutions would be paid?

A. No, sir. After they passed a resolution the order was carried out by the employees as directed.

Q. With respect to the Reserve for Zoning Hazard covered [70] by the resolutions contained in Petitioner's Exhibits 6 and 11, could the amounts covered by these resolutions be paid out to any members without any further act of the Board of Directors of the petitioner?

The Witness: What was the question?

(The question referred to was read by the reporter as above recorded.)

A. There is nothing in these resolutions directing anyone to pay anything to members. It was setting up this fund to be used for the purpose explained to you a moment ago and was taken from the overcharges that had been accrued through the season's business.

Q. (By Mr. Horrow) Referring to the Reserve for Security of Membership Fund covered by Petitioner's Exhibits 7 and 9, were those the reserves that are described in the bylaws of petitioner, page 27, Section 8? I show you the bylaws contained in Petitioner's Exhibits 1 and 2.

(Testimony of W. B. Roby.)

A. Now, the resolution—which one are you referring to?

Q. 7 and 9, the resolution relating to the Reserve for Security of Membership Funds.

A. Well, this Reserve for the Security of the Membership Fund is authorized and provided for in the bylaws, and the directors always before any patronage dividend was declared set aside that amount as belonging to the members to be placed in that fund for the purpose of protection against [71] loss and the supplying of capital working fund.

Q. That is covered by Section 8, page 27 of the bylaws?

A. Yes, sir.

Q. And under the resolutions to which we have been referring, Petitioner's Exhibits 7 and 9, could any amounts represented by these reserves be paid to any member or non-member of petitioner without authorization of the Board of Directors?

A. No money of any kind from whatever fund it came from could be paid to the members without authorization of the Board of Directors.

Q. Referring to Petitioner's Exhibit 4, the resolution relating to Reserve Against Loss by Overpayments for eggs, what was the purpose of that resolution?

A. The year during—during that year the returns to the members for the eggs that were marketed showed that the members had not received all the proceeds that had been received by the As-

(Testimony of W. B. Roby.)

sociation. At the end of that year the directors authorized the payment of a portion of that amount as a final payment at the end of the year on eggs marketed. The balance of it, which is referred to in this resolution, was set up as a protection against the overpayment of eggs at sometime in the future. The money was admittedly the members' money the same as any other fund that we had.

Q. You mean to protect the petitioner against any return [72] of excessive amounts to the members for whom eggs were marketed by the petitioner?

A. There are many ways in which there might be a loss in the marketing of eggs. It is very uncertain as to just what the returns will be always, and there is never any assurance that the amount paid will be received because of various things that may happen in the quoted market and in the marketing of the eggs, including expenses which might some times be very much different than others.

Q. So this reserve is to protect the petitioner against any possible loss in the future resulting from a miscalculation of the market price quoted to the members and a miscalculation as to the expenses incurred, is that right?

A. I think that would explain it, because it provides for an overpayment for any reason.

Q. And no amount represented by this reserve would be paid out except pursuant to authorization of the Board of Directors, is that correct?

(Testimony of W. B. Roby.)

A. It is kept in the fund the same as every other fund. And I repeat: that nothing could be taken out of any fund and paid to any member without the authorization of the Board.

Q. And none of the amounts which were represented by these reserves were segregated in any way from any funds or other property held by the petitioner? [73]

A. Except in a bookkeeping way. All the funds we had was kept in one fund.

Mr. Horrow: That is all, your Honor.

Redirect Examination

Q. (By Mr. Sapiro) And the credits were put on the books to the individual producer in proportion to the deductions that had been authorized?

A. Yes, sir.

Q. And then the Board of Directors would determine the time of payment?

Mr. Horrow: Now, just a moment! I think that is argumentative, your Honor, and I think it is very leading.

The Member: I think the witness has already brought that out, has he not? That the Board of Directors determined absolutely the payment.

Mr. Sapiro: No. That is just the difference, your Honor. The Board of Directors does not determine—that was the thing that I objected to when he was talking about payment. That is, if the obligation is owing, but the time of payment might be fixed by the Board. And your Board has ruled that in

(Testimony of W. B. Roby.)

cases, which I can cite to you, but will not at this time unless you want them——

The Member (interposing): I will overrule the objection. He may answer. [74]

Mr. Horrow: I think the question is highly leading, your Honor.

The Member: Will you rephrase your question?

Mr. Sapiro: Oh, pardon me.

Q. (By Mr. Sapiro) After these credits had been placed on the books for the individual producers what do the Board of Directors have to do with reference to payment?

A. These credits that are placed to the credit of each individual member constitute a whole. If operations of the Association are such that the members are entitled to either a refund or a dividend, which means the payment of their own interest on them, it is authorized only by the Board of Directors.

Q. As to these particular interests in these funds——

Mr. Horrow (interposing): Now, I think he has answered the question.

The Member: He is asking another question now.

Mr. Horrow: It is the same one.

Q. (By Mr. Sapiro) As to these particular interests in these funds, are those interests fixed on the books? A. Yes, sir.

Q. And has the Board of Directors taken any action as to time of payment? A. No, sir.

(Testimony of W. B. Roby.)

Q. Have they adopted any policy concerning the same? [75]

A. I don't quite get your point. Do you mean have they fixed any time at which they shall be paid?

Q. Or any policy for the payment?

A. Well, the policy for payment is that they shall be paid whenever the condition of these funds is such that they can be paid without detriment to the Association as a whole.

Q. I think that policy is embodied in that resolution, Petitioner's Exhibit No. 9, is it not? Is that the resolution to which you refer?

A. Yes, sir.

Q. If the Association did not secure the funds in this way it would have to borrow from outside sources, would it?

Mr. Horrow: Objection to that upon the ground it calls for a conclusion and is leading.

The Member: Sustained on the latter ground.

Q. (By Mr. Sapiro) What other sources would the Association have for securing funds?

A. The only way we have been able to get any fund was to borrow it, outside of the ones we got from the members accumulated in this way.

Mr. Sapiro: That is all.

Recross Examination

Q. (By Mr. Horrow) Now, Mr. Roby, when credits were paid to the accounts of members for the amounts represented by [76] this Reserve for

(Testimony of W. B. Roby.)

Zoning Hazard, what was it understood would be done to these credits if the petitioner were obliged to expend moneys to relieve itself of any zoning restrictions?

A. If the money had to be expended for that purpose, of course it would be an expense and it would be an expense of operation; either that or it would be an expense for capital construction.

Q. Was it understood that the credits to the members for that reserve would be removed?

A. Removed from what?

Q. From the accounts of the members.

A. All the money that the members have in the Association may be used by the Association for purposes set up in the bylaws.

Mr. Horrow: That is all.

A. (continuing) If it is so used it still is the property of the members, but if the money is not used then it may be paid back to the members in the form of dividends, either cash or certificates, which must be authorized by the directors.

Q. (By Mr. Horrow) And that applies to all of the reserves, is that correct, Mr. Roby?

Mr. Sapiro: Mr. Roby, I don't know whether you brought——

Mr. Horrow (interposing): I think he understands [77] and I think this question is very much to the point, your Honor.

The Member: You can bring that out on redirect, Mr. Sapiro.

(Testimony of W. B. Roby.)

The Witness: What was the question?

Q. (By Mr. Horrow) And your answer would be the same with respect to the credits made in the same accounts to the other reserves to which we have referred?

A. I think so. There is no other way that you can get at them.

Mr. Horrow: That is all, your Honor.

Redirect Examination

Q. (By Mr. Sapiro) Mr. Roby, if the money is used to build another building does that wipe out the member's right to have that credit paid to him?

A. No, sir. It merely—his interest is still in the Association the same as before. The money, if it is used to build a building, the member's interest is in the building rather than in the cash fund.

Q. That is, if the money is invested in the assets, the assets are still there?

A. Yes, sir.

Q. But the obligation of the Association to him is not changed? [78]

A. No, sir.

Q. Might that money be paid to him from subsequent deductions in the building up of that fund?

A. Yes, sir.

Q. Are the funds operated on a revolving fund basis?

A. Yes, sir.

Q. And the theory of that is that——

Mr. Horrow (interposing): Now, just a moment.

Q. (By Mr. Sapiro) What is the theory of the revolving fund basis of operation, Mr. Roby?

(Testimony of W. B. Roby.)

A. The revolving fund or the theory of the revolving fund is that deductions or “retains” are taken from the members and put into this revolving fund to be used as working capital or capital for construction purposes, and as it is replaced it goes back to the member. Then it is built up to a certain point—well, let me explain it this way.

Certificates are issued quite largely as a representation of the member’s interests in those funds. A fund may be built up to any amount fixed by the directors before it starts to revolve. Then when that point is reached that is fixed by the directors for the fund to revolve, then it revolves by the calling or redemption of the older certificates, and new money is issued, or new certificates are usually issued in place of them. And by doing it that [79] way the amount of the funds are held constant.

Q. That is, from deductions of the newer members’ participations the older is retired?

A. Yes, sir.

Mr. Sapiro: That is correct.

The Member: Any other questions?

Mr. Horrow: No.

Witness excused.

Mr. Sapiro: Mr. Franzich, please.

MR. RALPH H. FRANZICH

called as a witness on behalf of the petitioner, was examined and testified as follows:

(Testimony of Ralph H. Franzich.)

The Clerk: State your name, please?

The Witness: Ralph H. Franzich, F-r-a-n-z-i-c-h.

Direct Examination

Q. (By Mr. Sapiro) Mr. Franzich, you are employed by the San Joaquin Valley Poultry Producers Association? A. Yes, sir.

Q. In what capacity? A. Accountant.

Q. And you were such in '36 and '37?

A. I was; yes, sir.

Q. You have got the figures as to the volume and value of eggs marketed in '36 and '37?

Mr. Horrow: Objection to that upon the ground that [80] it is not relevant to the issue relating to the reserves.

Mr. Sapiro: Well, I am just following the allegations of the petition.

The Member: I will overrule the objection.

Mr. Horrow: Exception, please.

The Member: Exception noted.

A. Both, yes.

Q. (By Mr. Sapiro) Yes. And, if you could, give the proportion of the member and non-member business so long as you have got that?

Mr. Horrow: The same objection.

The Member: The same ruling.

Mr. Horrow: Exception.

A. I left the proportion on the table there on the members' and non-members' business.

Q. (By Mr. Sapiro) Where would that be? In this (indicating)?

(Testimony of Ralph H. Franzich.)

A. No. That's it (indicating).

The Member: I understood the question called for the amount of eggs sold.

The Witness: The amount of eggs sold. In dozens?

Q. (By Mr. Sapiro) In dozens or value.

A. O. K. The eggs amounted to \$727,978.01.

Q. That is in 1936?

A. That's 1936, yes. And in 1937 \$971,044.88.

[81]

Q. Do you have the figures there as to the feed?

A. Sales?

Q. Yes. A. Yes, I do.

Q. Feed and supplies.

A. That's right. In 1936 \$687,666.84 and in 1937 \$905,329.07.

Q. And those are dollars? A. That's right.

Q. You have got the percentages in both divisions as to member and non-member business?

Mr. Horrow: The same objection.

The Member: I will reconsider my ruling and sustain the objection to that.

Mr. Sapiro: If your Honor please, we allege in our petition, which is denied, in giving the history of the situation that in the year 1936 petitioner transacted a volume of business with non-members—that is on page 3—representing a certain percentage of the volume of eggs marketed, and the various percentages are given. Denied for lack of information and belief.

(Testimony of Ralph H. Franzich.)

The Member: I was not familiar with that allegation.

Mr. Horrow: It isn't material, your Honor, to the issues on the reserves.

The Member: It is alleged in the petition and it is [82] denied by the respondent, and I will let the evidence in. I cannot see very readily how it is material to any of the five errors that are specifically alleged in the petition.

Mr. Sapiro: We will argue that in the brief.

The Member: As I indicated to counsel, of course, the case will be held to the errors that are alleged there.

You may answer the question, Mr. Witness.

A. You asked what percentage there was of non-member business?

Q. (By Mr. Sapiro) Yes.

A. In 1936 in the feed division there was 10.47 per cent non-member business.

Q. That is what you call the purchasing division?

A. That is in the purchasing division. That is right. In 1937 there was .52 per cent non-membership business. In the marketing division in 1936 non-member business amounted to 1.77 and in 1937 .11 per cent.

Q. And that represented the eggs?

A. That's right.

Q. Now, you have with you ledger sheets of individual members?

A. I think I do, yes.

(Testimony of Ralph H. Franzich.)

Q. Is this the copy you made at my request?

A. This is the ledger sheet there (indicating).

This is the copy here (indicating). [83]

Q. Oh, this is the copy (indicating)?

A. Yes.

Q. These are three individual members of the Association that you brought up as a sample?

A. Yes, it is.

Q. And the other members who were members during that period have similar ledger sheets?

A. They do.

Q. What do those entries represent? Take one ledger sheet, for instance. What have you got? G. Boriack?

A. G. Boriack, yes. The entries in each of these retains is the amount set aside to the credit of this individual member.

Q. And is that his proportion?

A. That is his proportion of the retains for that year and to be paid to him later on in cash.

Q. On what is that proportion based?

A. Based upon the volume; I mean to say the volume of business that he does with the Association. In other words, if he brings in 1 per cent of the eggs brought into the Association, why, a deduction will be made accordingly or a reserve be set aside.

Q. And when it is calculated, then it is placed in the ledger in that manner?

A. That's right. [84]

(Testimony of Ralph H. Franzich.)

Q. And was that done at the end of each year?

A. That has been done at the end of each year, yes.

Q. You were in charge of the books?

A. Yes.

Q. And the entries in '36 and '37 were made when? Immediately after the end of the year?

A. Right after the end of the year, yes.

Q. And have been on the books in that manner?

A. That's right.

Q. The other ledger sheets are of similar nature?

A. That's right.

Q. Just different producers?

A. That's right.

Q. And this is similar to all the ledger sheets of the respective producers? A. Yes.

Q. But different in amount?

A. That's right.

Mr. Sapiro: We would like to offer the three exhibits as one exhibit.

Mr. Horrow: No objection.

The Member: Accepted in evidence.

The Clerk: Thirteen.

(The three ledger sheets so offered and received in evidence, were marked Petitioner's Exhibit No. 13 [85] and were made a part of this record.)

Q. (By Mr. Sapiro) Do you have copies of these?

A. No. That's the only ones I have here. I can make up copies for you though.

(Testimony of Ralph H. Franzich.)

Q. What is this statement of Membership Equity which I show you in the name of G. Boriack?

A. It's a statement sent to the members at the end of each year showing them their interest in the Association and also the total interest that the Association owns.

Q. As regards the particular fund?

A. That's right.

Q. Is that taken from the books?

A. That is taken from the books.

Q. Is that the total of the amount in the books on the respective funds?

A. That's right. On that date.

Q. And that is sent to the members?

A. That is sent to the members.

Q. And this one, which is in the name of G. Boriack, is a sample copy of those which are sent to all members? A. That's right.

Q. They differ in the amount of interest in the fund? A. They do.

Mr. Sapiro: We would like to offer that in evidence as next exhibit. [86]

Mr. Horrow: No objection.

The Member: Accepted in evidence.

The Clerk: Fourteen.

(The statement referred to was received in evidence and marked Petitioner's Exhibit No. 14 and was made a part of this record.)

Q. (By Mr. Sapiro) Mr. Franzich, you prepared these figures that appear in the petition on

(Testimony of Ralph H. Franzich.)

page 6 in reference to the analysis of the per cent of business done from members and non-members and the distribution of net income?

A. I do prepare the figures, yes.

Q. You prepared those for those years?

A. For those years I prepared those figures for those years between the division of the members and non-members.

Q. And you have checked those?

A. I have checked those, yes.

Q. And those figures are a correct disposition of the fund?

A. That's right. They are correct.

Mr. Horrow: Pardon me. I would like to object to that testimony upon the ground of relevancy and materiality. I would like to call your Honor's attention to page 7 of the petition in which the petitioner prays "That the Board determine that the taxable net income for 1936 should be calculated at an amount not in excess of \$880.58, and that the taxable net income for 1937 should be calculated at an [87] amount not in excess of \$144.06.

I submit that there is no issue in this case about tax exemption.

Mr. Sapiro: Let me just read this. We have pleaded this matter in the alternative, and it says on page 5, "Therefore, the petitioner contends that the taxable net income for the years 1936 and 1937, if complete exemption is not allowed, can only be calculated in the following manner . . ."

(Testimony of Ralph H. Franzich.)

That is, it was our contention and it has been through all the phases of this proceeding that the complete exemption should be allowed, but that if by any reason the Board took the position that complete exemption should not be allowed then the only portion of income that was taxable was that percentage of the income that might be allocable on a percentage basis of the business done to the non-membership business. And we prepared the calculation for the information of the Board.

The question I am addressing to him does not concern that particular calculation, but does the distribution as to whether the funds were distributed in the particular manner set forth there, and I asked him that general question, with the consent of counsel, not as to its relevancy, but just as to the method of producing it, if relevant, for the purpose of simplifying the proceedings. [88]

Mr. Horrow: I will say, Mr. Sapiro, that I am not prepared to go into this gentleman's allocations and his determination of percentage of business with members and non-members, and I am wholly unprepared to go into the question of tax exemption.

I don't know what methods were used by the petitioner in determining member and non-member business and how they allocated expenses, and what was done in respect of the determination of the figures and the allocations that they reflect.

Mr. Sapiro: How could you refrain from being prepared for that when it runs right throughout this petition, Mr. Horrow?

(Testimony of Ralph H. Franzich.)

Mr. Horrow: For the simple reason that any fair construction of this petition would not lead anyone to believe that tax exemption is an issue.

The Member: Well, I will say, as I have said three or four times before, that so far as I am concerned the issues of this case are those set out specifically on page 2, paragraph 4, subdivision (a), (b), (c), (d) and (e), alleging five errors on the part of the Commissioner.

Mr. Sapiro: Yes. But your Honor, let me say as to that, we do allege that those are the five errors, that he refused to allow the deductions. Now, then, we go on and state the facts constituting the basis of our contention [89] that the refusal was erroneous, and in those facts we clearly set forth both the factor we claim that it is exempt from income, and that these particular moneys belong to the members and had been dedicated to them by appropriate action of the Association, both in its bylaws and by the action of the Board of Directors.

If this were an exempt corporation, then his failure to permit the deduction of the reserve is error. As I read the rules of the Board of Tax Appeals it says you shall state where the Commissioner has erred. Then you shall state the grounds of your objection to the Commissioner's action.

Now, we state that the Commissioner has erred in that he has refused to allow as deductible from gross income these amounts.

I don't want to take the time arguing the law of the

(Testimony of Ralph H. Franzich.)

case as to what constitutes proper deductions under the income tax exemption given to cooperative associations, but if he didn't allow a proper deduction then he committed error. So we have not misled anybody at any state of this case. After all, it certainly is not our desire to try a proceeding of this kind by misleading counsel.

We have at all times set forth in here the non-profit nature of the operation and the nature of the Association. [90]

We do say, and I might say this: That we made that contention before the various examining agents that had this matter in hand and we assume, of course, that the matter goes up through the department on their side the same way as the information comes up to us on our side, that the Association should be regarded as an exempt association, but that in any event, whether it is exempt or not, the only thing that was taxable was that proportion of the net income which could be allocable to non-member business on a proportionate basis, a method that the Commissioner has many times adopted in reference to cooperatives.

Now, all that I am asking this witness at this time is, Isn't it a fact that the particular amount set forth, not that that concludes support of the allegation, but are the particular amounts set forth the correct amounts as shown by his books? Here is a record prepared by him.

Mr. Horrow: Let me say that there were several reserves that were disallowed as deductions by

(Testimony of Ralph H. Franzich.)

the respondent. No mention of those reserves is made in the petition. So I can't understand counsel saying that the basis for the assignment of error in respect to the reserves is due to the fact that they contend that the petitioner is tax exempt. If that was their contention they would have taken up all the other reserves which are disallowed in the notice of deficiency. Anybody looking [91] at that prayer could not help but come to the conclusion that petitioner is conceding that it is taxable and wants its taxable net income reduced to the figures which it sets forth, as I have indicated, on page 7.

Mr. Sapiro: If that were the only issue, Mr. Horrow, then this evidence that I am now asking this witness is completely relevant to that issue.

Mr. Horrow: It is completely irrelevant, in my opinion.

Mr. Sapiro: Oh, no. If you claim that the only issue is that these should be the taxes, then we are asking him whether or not these figures are correct, which are the basis on which we calculate the request for that tax.

Mr. Horrow: I just state that my objection is, that the question of tax exemption is not an issue and the evidence is related to that issue and it is therefore irrelevant.

Mr. Sapiro: No, this evidence isn't, Mr. Horrow.

The Member: I agree with you perfectly in regard to your major contention, Mr. Horrow, but

(Testimony of Ralph H. Franzich.)

I am not prepared to say that this testimony is not relevant.

Mr. Horrow: Then I have no objection to letting it go in.

The Member: All right. With that understanding you may answer. [92]

Mr. Sapiro: You have no objection to my proving it in this method, other than its relevancy?

Mr. Horrow: No. I have no objection to your using summaries.

Q. (By Mr. Sapiro) I think the question was whether those figures as contained on page 6 of the petition are correct and accurate statements of the distribution of the funds. A. They are.

Q. Involved? A. They are.

Q. And the percentages?

A. They are correct.

The Member: That is, limiting it as reflected by the books of the corporation?

Mr. Sapiro: Yes.

Q. (By Mr. Sapiro) Limiting it as reflected by the books of the corporation and as ascertained by you from the books of the corporation?

A. That is correct.

Mr. Sapiro: That is all of this witness.

Mr. Horrow: Just one or two questions, your Honor.

Cross Examination

Q. (By Mr. Horrow) How did you treat Patronage Dividend on the books of petitioner? [93]

(Testimony of Ralph H. Franzich.)

A. What do you mean by that question?

Q. What entries were made when patronage dividends were declared or paid?

A. The members were credited with the amount of the declared dividend.

Q. Taking the exhibit which is in evidence, the ledger sheets which you have identified, are they any items on those sheets that reflect patronage dividends?

A. They are patronage dividends.

Q. You consider that all of those amounts are patronage dividends? A. That's right, sir.

Q. I show you the resolution, Petitioner's Exhibit 10, Patronage Dividend, and ask you to point out the entries that were made in that account by reason of that resolution?

A. They were made on this account here?

Q. Yes, the accounts that you have.

A. They are not on this account here.

Q. What account are they in?

A. There is a separate ledger sheet for them also, and the 25 per cent of it was paid to them in cash and the other is paid to them as the fund grows up.

Q. Do you have a sample of that other ledger sheet to which you have reference?

A. Not with me. No, I haven't. [94]

Q. At any rate the amounts covered by resolution, Petitioner's Exhibit 10, are not reflected in any way on the ledger sheet?

(Testimony of Ralph H. Franzich.)

A. Not on that ledger sheet there, no.

Q. And the same is true with respect to the patronage dividend covered by the resolution contained in Petitioner's Exhibit No. 5, which I show you?

A. That's right.

Q. Will you explain this column "Contingencies" which appears on the exhibit covering the ledger accounts? What items are credited to those accounts, to those columns?

A. Items so decreed or passed by the board.

Q. What is the nature of the items which appear as credits in the column headed "Contingencies"?

A. What is the nature of it? I don't quite get you.

Q. What type of items appear as reflect the credits in that column? I ask you whether or not there was a reserve for legal and auditing expense during the year 1936.

A. I think there was. Now, I won't say that.

Q. And the items represented by that reserve appear as credits in the column "Contingencies", isn't that correct?

A. No, sir.

Q. What items appear in this column "Contingencies"?

Mr. Sapiro: I think it is obvious that there is no '36 item in these contingencies.

Mr. Horrow: He is describing the——[95]

Mr. Sapiro (Interposing): I mean you asked him first about legal and auditing expense of '36.

Mr. Horrow: Well, there was one for '37.

(Testimony of Ralph H. Franzich.)

Mr. Sapiro: But there is no item of Contingency in '36 or '37.

Q. (By Mr. Horrow) Can you explain what this column "Contingencies" is used for?

A. It is used to set up the credit which the directors have authorized to these members for overcharges through patronage.

Q. Why is the account headed "Contingencies"?

A. It is so decreed by the directors.

Q. You mean to say that that account was set up by action of the Board of Directors?

A. It is set up by resolution.

Mr. Horrow: I won't take up any more of your Honor's time on this.

Q. (By Mr. Horrow) Referring now to the statement of membership equity, isn't it a fact that the total of these amounts which appear on these statements sent out to members, that total is equal to the difference between the book value of the assets and the liabilities of petitioner?

A. That's right.

Mr. Horrow: That's all, your Honor.

The Member: Any redirect? [96]

Redirect Examination

Q. (By Mr. Sapiro) I understand you to say that there are separate ledger sheets covering other accounts? A. There are, yes.

Q. When you said "total of the book value of assets and liabilities" of the petitioner, what did you mean by that?

(Testimony of Ralph H. Franzich.)

A. Repeat that again.

The Member: What did you mean by saying "total of book value of assets"?

Q. (By Mr. Sapiro) Mr. Horrow asked you whether or not some total represented the difference between the book value of the assets and liabilities of petitioner. What do you mean by that?

A. I don't get the question yet, to be frank with you.

Q. Did you understand the question?

A. I must have misunderstood his question, then.

Q. To what amounts did he point as the total? The total of the sums of these various funds?

A. This is the capital belonging to the members.

Mr. Horrow: The total of all those amounts represents the net worth as shown by the books of petitioner?

The Witness: That's right.

Mr. Horrow: I think he understood, your Honor.

The Member: Any other questions?

Mr. Horrow: I have no further questions. [97]

Mr. Sapiro: That is all.

Witness excused.

The Member: Petitioner rests?

Mr. Sapiro: Petitioner rests.

The Member: Respondent rests?

Mr. Horrow: Respondent rests.

The Member: Briefs will be filed: Opening briefs forty-five days and reply briefs in thirty days.

Hearing concluded.

[Endorsed]: U. S. B. T. A. Filed Jul. 8, 1941. [98]

PETITIONER'S EXHIBIT No. 1
SAN JOAQUIN VALLEY POULTRY
PRODUCERS ASSOCIATION
BY-LAWS [99]

State of California
Department of State

I, Frank C. Jordan, Secretary of State of the State of California, do hereby certify that I have carefully compared the transcript, to which this certificate is attached, with the record on file in my office of which it purports to be a copy, and that the same is a full, true and correct copy thereof. I further certify that this authentication is in due form and by the proper officer.

In Witness Whereof, I have hereunto set my hand and have caused the Great Seal of the State of California to be affixed hereto this 3rd day of June, A. D., 1925.

[Seal]

FRANK C. JORDAN,

Secretary of State

By FRANK H. CORY,

Deputy. [100]

Petitioner's Exhibit No. 1 (Continued)

Articles of Incorporation
of
San Joaquin Valley
Poultry Producers Association

Know All Men by These Presents:

That, we, the undersigned, all of whom are residents of the County of Tulare, State of California, engaged in the production, packing and marketing of agricultural products, have this day associated ourselves together for the purpose of forming a non-profit co-operative association under the provisions of Title 23, Part IV, Division One of the Civil Code of the State of California, and we do hereby certify:

I.

That the name of the Association shall be:

“San Joaquin Valley Poultry Producers Association.”

II.

That the purposes for which said Association is formed are as follows:

To engage in any activity in connection with the production, marketing, selling, packing, grading, storing, handling or utilization of any poultry eggs, or other agricultural products produced or delivered to it by its members, or by non-members, to an amount not greater in value than the value of such products as are dealt in or handled by it for its own members;

Petitioner's Exhibit No. 1 (Continued)

To engage in any and all said activities with reference to the by-products of any such agricultural products;

To purchase, transport, sell, handle, deal in all supplies, trademarks and patents, machinery and equipment useful or necessary to the production,

[101]

marketing, care, maintenance or protection of any of said agricultural products;

To engage in any activity in connection with the purchase, hiring or use by its members of supplies, machinery, and equipment, or in the financing of any such activity;

To borrow money;

To loan and advance money to the members of the Association in connection with any of the said activities upon adequate security;

To establish reserves, and to invest the funds thereof in bonds, or any such other property or security as may be provided in the By-Laws;

To buy, hold and exercise all privileges of ownership over such real or personal property as may be necessary or convenient for the conduct and operation of any of the business of the Association, or incidental thereto;

To levy assessments in the manner, and in the amount as may be provided in its By-Laws;

To do each and everything necessary, suitable or proper for the accomplishment of any one of the purposes, or the attainment of any one or more of the subjects herein enumerated, or conducive to, or

Petitioner's Exhibit No. 1 (Continued)

expedient for the interests or benefit of the association, and to contract accordingly; and in addition to exercise and possess all powers, rights and privileges necessary or incidental to the purposes for which the Association is organized, or to the activities in which it is engaged.

This Association shall conduct and carry on its business without profit to itself, and shall not make, declare or pay to its members any dividend on membership certificates. It may, however, use or employ any of its facilities for any purpose, and the proceeds arising from such use and employment shall go to reduce the costs of operation for its members and products of non-members similar to the products handled for its members may be dealt in to an amount not greater in value than such as are handled by it for its members.

III.

That the place where the principal business of the Association will be transacted is the City of Porterville, Tulare County, California. [102]

IV.

That the said corporation shall have perpetual existence, and that the term for which said corporation is to exist, is perpetual.

V.

That the number of Directors of the said Association shall be seven, all of whom shall be members of the Association.

Petitioner's Exhibit No. 1 (Continued)

1. One Director shall be a member residing in the Madera District comprising all of Madera County, and shall be elected by the members of said Madera District.

One Director shall be a member residing in Fresno District comprising all of Fresno County except that portion lying south of the Kings River and including that portion of Tulare County lying north of the Kings River and including that portion of Kings County lying north and west of the Kings River, and shall be elected by the members of said Fresno District.

Four Directors shall be members residing in the Porterville District comprising all that territory in the San Joaquin Valley not included in the Madera and Fresno Districts, and shall be elected by the members of said Porterville District.

One Director shall be a Director-at-Large elected by all the members and may reside in any of the Districts.

2. The term of office of the Director-at-Large shall be for one year and he shall be elected annually; the term of office of all other Directors shall be for two years; provided, however, that at the first annual election after the adoption of this amendment three Directors shall be elected for two years, one of whom shall be from the Fresno District and two from the Porterville District and three Directors shall be elected for one year, one of whom shall be from the Madera District and two from the Porterville District, with the further proviso that

Petitioner's Exhibit No. 1 (Continued)
of the Directors elected from the Porterville District the two receiving the highest number of votes shall be elected for the two year term and the other two for the one year term; and that at all subsequent annual elections all retiring Directors except the Director-at-Large shall be replaced by the election of an equal number from the same district for the full term of two [103] years, and until their successors are elected and qualified.

That the names and residences of those who are to serve as incorporating Directors and until their successors are elected and qualified are as follows:

H. S. Williams, Porterville, California.

C. A. Cohenour, Porterville, California.

L. R. Longley, Porterville, California.

F. M. Crabtree, Porterville, California.

Elmer DeMott, Porterville, California.

VI.

The property rights and interest of each member in the property and assets of the Association shall be unequal; in the event of liquidation of the affairs of the Association the assets of the Association shall be distributed in accordance with the following rule:

If at the end of the period for which this Association is organized the members do not elect to continue the Association, or if at any other period prior thereto the members shall elect to discontinue the operation of the business of the Association, the Directors with the consent of two-thirds of the

Petitioner's Exhibit No. 1 (Continued)

members of the Association, shall sell the assets and property of the Association, and shall apply the proceeds upon the indebtedness and liabilities of the Association in the following order of priority:

1st. They shall pay all indebtedness and liability of the Association other than that represented by the Feed Finance Fund, the Advance Fund and the Membership Fund.

2nd. If, thereafter, there shall be any remainder, and only in such event, they shall pay pro-rata the holders of Feed Finance and Fund Certificates and Advance Fund Certificates not to exceed the face value thereof, together with all accrued interest.

3rd. If, thereafter, there shall be any remainder, and only in such event, they shall divide and pay in equal amounts to each member of the Association an amount not to exceed the face value of the Membership Certificates.

4th. If, thereafter, there shall be any remainder, and only in such event, they shall pay [104] pro-rata to the holders of the Feed Finance Fund Certificates and Advance Fund Certificates outstanding all of the balance of the assets of the Association; such payments shall be pro-rated to the members in accordance with the amount of purchases from the Association made by each member during the period in which such Feed Finance Fund Certificates and Advance Fund Certificates may have accumulated.

VII.

The Association shall issue to each member a certificate of membership; but neither said member-

Petitioner's Exhibit No. 1 (Continued)

ship nor said certificate may be assigned by any member or by act of law; nor shall any assignee or transferee thereof receive or be entitled to any rights or interests in the Association unless the Board of Directors expressly authorizes such assignment or transfer, and expressly accepts the said assignee or transferee as a member of the Association.

The Association, by action of the Board of Directors, shall have the full right to purchase the full interest of any member in the property or other rights of the association, at the book value thereof, whenever, in the judgment of said Board, it is in the general interests of the Association so to do, and the statement of book value thereof by the Board of Directors, shall be conclusive. Any member whose rights are so purchased shall cease to be a member of the Association and his Membership Certificate shall thereupon be cancelled.

VIII.

The Association may provide in its By-Laws the terms and conditions upon which membership may be transferred or assigned and conditions upon which, and the time when, membership may cease, and the mode, manner and effect of the expulsion of a member, and the method, time and manner of withdrawal, and the right of members to vote by proxy or by mail and any other thing in furtherance of, but not in conflict with, these articles.

Petitioner's Exhibit No. 1 (Continued)

In Witness Whereof, we have hereunto set our hands on the 26th day of May, 1925.

H. S. WILLIAMS

C. A. COHENOUR

F. M. CRABTREE

L. R. LONGLEY

ELMER DEMOTT [105]

State of California,
County of Tulare—ss.

On this 26th day of May, in the year One Thousand Nine Hundred and Twenty-five, before me, Alice Deleray, a Notary Public in and for the County of Tulare, personally appeared H. S. Williams, C. A. Cohenour, L. R. Longley, F. M. Crabtree and Elmer DeMott, known to me to be the same persons whose names are subscribed to the within instrument, and they duly acknowledged to me that they executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal, at my office, in the County of Tulare, the day and year in this certificate first above written.

ALICE DELERAY,

[Seal]

Notary Public in and for the
County of Tulare, State of
California.

State of California,
County of Tulare—ss.

I, Gladys Stewart, County Clerk of the County of Tulare, State of California, and ex-officio Clerk

Petitioner's Exhibit No. 1 (Continued)
of the Superior Court in and for said County, hereby certify the within and foregoing to be a full, true and correct copy of the original Certified Copy of Articles of Incorporation as the same now remains of record and on file in my office in the therein entitled matter.

In Witness Whereof, I have hereunto set my hand and affixed the seal of the above named Court this 6th day of June, 1925.

GLADYS STEWART,

Clerk.

By TROY OWEN,

Deputy Clerk. [106]

By-Laws

of

San Joaquin Valley

Poultry Producers Association

Article I

Name, Place and Purpose

Section 1. The name of this Association is and shall be the San Joaquin Valley Poultry Producers Association.

Section 2. The principal place of business shall be Porterville, Tulare County, California.

Section 3. The purpose of this Association is to provide for its members a collective system of marketing of poultry, poultry products or other agricultural products; to furnish to them any feed, seed or supplies, and to the end of lessening the cost of such service, to do the same things for those who

Petitioner's Exhibit No. 1 (Continued)
are not members, all of which is more particularly
set forth in the Articles of Incorporation.

Article II

Corporation Seal

Section 1. The corporation Seal shall consist of
a circle, having within its circumference the words,
"San Joaquin Valley Poultry Producers Associa-
tion, Incorporated June 3, 1925."

Article III

Members and Their Relation to the Association Membership

Section 1. The Association does and shall con-
sist of poultrymen and other agricultural producers
who shall have been duly elected and shall have paid
[107]
the membership fee of Ten (\$10.00) Dollars. No
member shall hold more than one membership.

Eligibility

Section 2. Membership in the Association shall
be limited to such persons, firms, Associations or
Corporations as are engaged in the production of
eggs, poultry or other agricultural products, includ-
ing lessees and tenants of land used for the produc-
tion of such products, and any lessors or landlords
who receive as rent all, or part of the production
from such leased premises.

Membership Fee

Section 3. The membership fee shall be Ten
(\$10.00) Dollars and must be paid in cash at the
time application for membership is made. Appli-

Petitioner's Exhibit No. 1 (Continued)

cants for membership shall deposit the membership fee of Ten (\$10.00) Dollars and file a written application with the Secretary in which he, she or it agrees to be bound by the By-Laws of the Association and to which he, she or it thereby subscribes. If application is accepted by the Board of Directors, the applicant becomes a member in good standing and is entitled to all the benefits of the Association and shall be bound and engaged by the By-Laws of the Association; if the application is rejected all moneys shall be returned.

Assignment of Membership

Section 4. No membership nor any certificate of membership shall be assigned by any member to any other person, nor shall a purchaser at execution sale or any other person who may succeed by operation of law or otherwise, to the property interests of a member be entitled to membership or become a member of the Association by virtue of such transfer.

The Board of Directors of the Association may, however, consent to any assignment or transfer and the acceptance of the assignee or transferee as a member of the Association shall make such assignee or transferee a member of the Association and such assignee or transferee, when accepted, shall be bound by the By-Laws of the Association.

Withdrawal of Membership Fee

Section 5. No membership fee may be withdrawn from the Membership Fund by any member except the Board of Directors may deem it ad-

Petitioner's Exhibit No. 1 (Continued)
vis- [108] able and at their discretion redeem such membership to the Association.

Member May Be Expelled

Section 6. If in the judgment of a majority of the Directors, the conduct of any member has been injurious to the Association, the said Board of Directors, after preferring charges and giving a hearing upon fifteen days' notice, shall, by a concurrence of five Directors, have the power to expel such member; an expelled member may, however, upon a petition signed by a majority of all the members of the Association, be reinstated.

In all cases an expelled member shall within thirty (30) days receive the amount of his Membership Fee and the amount of any Feed Finance Fund Certificates or Advance Fund Certificates or other indebtedness due him by the Association, less any indebtedness or loss to the Association caused by him.

Deceased Member

Section 7. The Directors shall determine the mode and manner of the settlement of a deceased member's account and the time of payment in such cases and also the mode and manner of succession to membership and the transfer of Membership Certificate.

Annual Meeting of Members

Section 8. The Annual Meeting of members of the Association shall be held on the third Monday of February of each year, at the main office of the

Petitioner's Exhibit No. 1 (Continued)

Association, commencing at ten o'clock A. M., provided, however, that the Directors may, at their discretion, change the meeting to some other place and to some other hour, by giving due notice of such change in the regular Annual Meeting notices which are to be mailed to each member, as provided for elsewhere in these By-Laws. No matter shall be voted upon at said meeting which has not been previously submitted to the members.

Notice of Business to Be Transacted

Section 9. Any member desiring to have any matter of business acted upon by vote of members at any Annual Meeting shall prepare and present such matter in proper written form to the Secretary of the Association on or before twenty (20) days prior to the day fixed for said Annual Meeting. [109]

Special Meeting of Members

Section 10. Special meetings of the members may be called by the President of the Association or by a majority of the Board of Directors, and shall be called upon the written request of one-tenth (1-10th) of all the members; when a written request signed by one-tenth (1-10) of all the members shall have been filed with the Secretary asking to have a special meeting called for any purpose it shall be mandatory with the Directors to send proper legal notice to all members within fifteen (15) days after having received such written notice.

All such calls shall be in writing and shall state the time and place and purpose of such meeting.

Petitioner's Exhibit No. 1 (Continued)

No business shall be transacted at any special meeting other than as is stated in the purpose of the call.

Notice of Annual Meeting

Section 11. Notice of the Annual Meeting of members shall be given, stating the time and place of the meeting; this notice must contain an itemized list of all matters that may be voted upon at such meeting; a copy of such notice shall be mailed to each member as his, her or its address shall appear on the books of the Association, at least ten days prior to the time for holding such meeting.

Notice of Special Meetings

Section 12. Notice of special meetings of members shall be given by mailing to each member, as his, her or its address shall appear on the books of the Association, a copy of the call for such meeting, at least ten days prior to the time fixed for such meeting.

Quorum

Section 13. At any meeting of members of the Association, ten (10) per cent of all of the members, represented either in person or by proxy, shall constitute a quorum for the transaction of business.

Vote

Section 14. Each member shall have at least one (1) vote and shall have one (1) additional vote for each Ten (\$10.00) Dollars of Advance Fund Certificates or Feed Finance Fund Certificates held by said member except that no vote shall be allowed

Petitioner's Exhibit No. 1 (Continued)
for any Advance Fund Certificates or Feed Finance
[110]

Fund Certificates acquired by transfer or assignment direct or indirect or by operation of law.

All voting by ballot, whether mailed ballot or otherwise, shall be based on both membership, Advance Fund Certificates and Feed Finance Fund Certificates as provided in preceding paragraph.

All other voting shall be based on membership only.

Any member shall have the right to demand a vote by ballot unless the matter under consideration is specifically provided for in these By-Laws.

Cumulative Voting Prohibited

Section 15. Cumulative voting is hereby expressly prohibited at all elections held by this corporation.

Referendum

Section 16. Ten (10) per cent of all the members may invoke the referendum on any matter decided at any meeting of members where the deciding vote cast was less than a majority of all members of the Association.

Property Rights

Section 17. The property rights and interest of each member in the property and assets of the Association shall be unequal, and in the event of liquidation of the affairs of the Association the assets shall be distributed in accordance with the rules set forth in Article IX of these By-Laws.

Petitioner's Exhibit No. 1 (Continued)

Article IV
Corporate Powers
Directors

Section 1. Except such as are reserved by statute or these By-Laws to be exercised by the Association as a whole, the corporate powers of this Association are, and shall be vested in a board of seven (7) Directors, all of whom shall be members of the Association, actively engaged in some branch of poultry raising and shall be actively supporting the Association by using its facilities in the operation of his business. [111]

Directors Represent Districts

Section 2. One Director shall be a member residing in the Madera District comprising all of Madera County, and shall be elected by the members of said Madera District.

One Director shall be a member residing in the Fresno District comprising all of Fresno County except that portion lying south of the Kings River and including that portion of Tulare County lying north of the Kings River and including that portion of Kings County lying north and west of the Kings River, and shall be elected by the members of said Fresno District.

Four Directors shall be members residing in the Porterville District comprising all that territory in the San Joaquin Valley not included in the Madera and Fresno Districts, and shall be elected by the members of said Porterville District.

One Director shall be a Director-at-Large elected

Petitioner's Exhibit No. 1 (Continued)

by all the members of the Association and may reside in any of the Districts.

Term of Office of Directors

Section 3. The term of office of the Director-at-Large shall be for one (1) year and he shall be elected annually; the term of office of all other Directors shall be for two (2) years; provided, however, that at the first annual election after the adoption of these By-Laws, three (3) Directors shall be elected for two (2) years, one of whom shall be from the Fresno District and two (2) from the Porterville District, and three (3) Directors shall be elected for one (1) year, one of whom shall be from the Madera District and two from the Porterville District, with the further proviso that of the Directors elected from the Porterville District the two receiving the highest number of votes shall be elected for the two year term and the other two for the one year term; and that at all subsequent annual elections all retiring Directors except the Director-at-Large shall be replaced by the election of an equal number from the same district for the full term of two (2) years and until their successors are elected and qualified.

Qualifying of Directors

Section 4. The newly elected Directors shall on or before entering upon the duties of the office, subscribe to the following obligation, written in the Minute Book of the Association:

"The undersigned having been duly elected as a Director and officer of the San Joaquin Valley

Petitioner's Exhibit No. 1 (Continued)

Poultry Producers Association, at the election held
 , do promise to faithfully and
 honestly perform the duties of said office, and to
 advance and support the best interests of the As-
 sociation.

"Signed this day of

"

Organization

Section 5. Within one week following their elec-
 tion, the Directors shall meet, qualify and organize
 by electing a President, and one or more Vice-
 Presidents from among their number; they shall
 also elect a Secretary, a Manager and a Treasurer,
 who may or may not be members of the Association
 or of the Board of Directors, and they may select
 whatever other officers or employees they deem
 necessary.

Meetings of Directors

Section 6. The Board of Directors shall hold
 regular monthly meetings on such date as may from
 time to time be fixed by resolution of its said Board,
 notice of which shall be given to the members by
 publication in the Association's monthly bulletin or
 other suitable publication or publications published
 in the territory in which the Association members
 reside.

Special meetings of said Board of Directors shall
 be held upon the call of the President, or upon the
 request of a majority of the Directors, and notice
 of not less than twenty-four (24) hours shall be

Petitioner's Exhibit No. 1 (Continued)

given to each member of the Board of Directors of any and all special meetings, unless such notice be waived in writing.

Vacancies

Section 7. Vacancies occurring in the Board of Directors shall be filled by appointment of the Directors from the District in which the vacancy occurs or the Board of Directors may call a special meeting of the members in that District for the purpose of filling said vacancy; in the event a Director is legally recalled, the vacancy is filled by recall petition or election naming new Director or Directors. [113]

Recall

Section 8. Any member may bring charges against an officer or Director from his, her or its District by filing them in writing with the Secretary of the Association, together with a petition signed by twenty (20) per cent of the members of said District, requesting the removal of the officer or Director in question. The removal shall be voted upon at a special meeting of the members of said District which shall be called for the purpose by the Directors, and by a majority vote, voting by ballot, the members of the District may remove the officer or Director and fill the vacancy.

The Director or officer against whom such charges have been brought shall be informed in writing of the charges previous to the meeting, and shall have an opportunity at the meeting to be heard in person, or by counsel, and to present witnesses, and the

Petitioner's Exhibit No. 1 (Continued)
person or persons bringing the charges against him shall have the same opportunity.

Forfeiture of Office

Section 9. The absence of a Director from three (3) consecutive regular meetings (unless from some unavoidable cause to be determined by the Board of Directors) shall be deemed to be and shall act as a resignation, and the Directors may proceed to fill the vacancy until the next regular Annual Meeting of the members of the Association.

Quorum

Section 10. A majority of the Board of Directors shall constitute a quorum for the transaction of business at any Directors' meeting.

No Director shall be entitled to vote upon any question of his or a relative's employment, or upon any question in which he is financially interested other than as a member of the Association.

A concurrence of a majority of all Directors shall be necessary for the transaction of business involving an officer or an office, and expenditure of money other than in the regular and ordinary course of business or a capital investment of money exceeding Five Hundred (\$500.00) Dollars.

Powers and Duties of the Directors

Section 11. The Directors shall have the power and it shall be their duty: [114]

1st. To convene all regular meetings of the Association, and to call special meetings of the Association upon the written request of ten (10) per

Petitioner's Exhibit No. 1 (Continued)

cent of the members, or when they may deem it necessary.

2nd. To admit or reject members.

3rd. To appoint or remove and have control of such subordinate agents, employees and officers as the business may require, prescribe their duties, fix their compensation, and require from persons appointed to any office or employment, having the receipt, management or expenditure of money or goods of value on account of this Association, such security or bond as they may deem necessary.

4th. To make rules for the management of the business of the Association and any branches of the business in which the Association may engage.

5th. To enter into any and all contracts essential to the transaction of its affairs, for the purpose for which it was formed; to borrow money and to issue all such notes, mortgages, or other evidences of indebtedness or security for indebtedness, as may be necessary to properly conduct the business of the Association and to transact all of the business of the Association in its proper corporate name.

6th. To act on all grievances and complaints and to consider and determine the same.

7th. To attend all meetings of the Association.

8th. To cause to be kept a complete record of all their proceedings and acts, and also the proceedings of the Association.

9th. To cause the business of the Association to be regularly entered in the proper books in such manner and in such form that it can be determined

Petitioner's Exhibit No. 1 (Continued)

at any time, the correct financial condition of the Association and what portion of the receipts from all sales, after deducting operating expense, overhead and duly authorized reserves or other proper deductions, properly belongs to each and every member.

10th. To make the members of the Association a full report annually showing the receipts and disbursements during the year, with a complete statement of assets and liabilities. [115]

11th. To annually take stock of all corporate property and business and cause a statement of the accounts of the Association, with all necessary vouchers, up to the first day of January of each year, to be made out and laid before the regular Annual Meeting of the Association.

12th. To cause to be issued Certificates of Membership.

13th. To fill all vacancies occurring in any office of the Association until the first regular annual meeting of the Association following such vacancy except as otherwise provided by statute or these By-Laws.

14th. To employ an expert accountant to expert the books and accounts quarterly and submit once each year, after January first, a report of the year's business to the members at the Annual Meeting of the Association.

15th. To create and maintain an Advance Fund and to deduct or cause to be deducted from the proceeds of sale of each member's eggs such an amount, not exceeding one (1) cent per dozen, as they may

Petitioner's Exhibit No. 1 (Continued)

deem advisable, to be applied to the creation and maintenance of the said Advance Fund as provided for in these By-Laws, and to issue or cause to be issued duly authorized Advance Fund Certificates to each member covering such deductions.

16th. To create and maintain a Feed Finance Fund as provided for elsewhere in these By-Laws, and to issue or cause to be issued "Feed Finance Fund" Certificates to each member as his, her or its prorated interest may be, as determined by said member's purchases from the Association during the period covered by the computation and as provided for in these By-Laws.

17th. To consent to, or for proper cause to restrict or make provision for the restriction of the transfer or assignment of Advance Fund or Feed Finance Fund Certificates or any other certificates of interest in any fund held by it; provided, however, that action in the premises may be taken by any committee or officer authorized so to do by the Board of Directors.

18th. To create and maintain a Reserve Fund for security of the Membership Fund, as authorized in these By-Laws or by proper resolution duly adopted to create and maintain any other Reserve Fund or Funds for any purpose and in whatsoever [116] amount they may deem advisable for the best interests of the Association.

19th. After making such financial provisions as are directed by these By-Laws and as they deem for the best interest of the Association, and as the business of the Association may warrant, to refund

Petitioner's Exhibit No. 1 (Continued)

to the members in proportion to the amount of business done by each with the Association, the balance of any overcharges from sales, all as provided for elsewhere in these By-Laws.

20th. To select one or more banks to act as depository of the funds of the Association and to determine the manner of receiving, depositing and disbursing the funds of the Association and the form of checks and the person or persons by whom same shall be signed, with the power to change such banks and the person or persons signing such checks and the form thereof at will.

21st. To surrender to their successors who have been duly elected and qualified, the custody of all of the records or property of the Association.

22nd. To levy assessments whenever required to pay outstanding obligations of the Association, or maintain and carry on the business of the Association, to provide the time, manner and place of payment of any such assessment and the mode or manner of securing or enforcing payment thereof; to collect any such assessment either by action at law or by sale of the Membership Certificate of any delinquent member and if collected by sale of the Membership Certificate, to provide the time, place and manner of sale, and the sale of any Membership Certificate shall forfeit all the right, title and interest of the delinquent member in the property and assets of the Association, but shall not relieve the Association of its obligation under any outstanding Advance Fund Certificate held by said delinquent member.

Petitioner's Exhibit No. 1 (Continued)

23rd. The Directors of the Association shall receive such compensation for their time and such remuneration for their traveling expenses as the said Board of Directors may at their discretion allow, provided, however, that no Director shall receive any compensation except for time actually spent in attendance at a regular or special meeting of the Directors and for miles actually and necessarily traveled in attending such regular or special meetings of Directors, and provided further that no Director shall receive in excess of Five (\$5.00) Dollars [117]

lars in any one month for his time nor more than five (5) cents per mile for miles necessarily and actually traveled in attending regular or called meetings of said Board.

24th. To perform and do all other necessary acts to be done for the purpose of carrying into effect the object for which this Association was formed.

Article V

Executive Committee

Appointment

Section 1. The Board of Directors may appoint or provide for the appointment of an Executive Committee to consist of as many of its members as it may designate. The Executive Committee shall conduct the business and affairs of the Association during the interim between Board Meetings but subject to the general control of the Board of Directors.

Petitioner's Exhibit No. 1 (Continued)

Minutes and Records

Section 2. It shall be the duty of the Executive Committee to keep full minutes and records of all of its acts and proceedings and submit the same to the Board of Directors for approval.

Powers Granted

Section 3. The Executive Committee may perform such duties and have such powers as may from time to time be delegated to it by resolution of the Directors, limited only by statute and these By-Laws.

Vacancies

Section 4. Vacancies in the Executive Committee shall be filled by the Board of Directors.

Article VI

Officers

Section 1. The officers of this Association shall be a President, one or more Vice-Presidents, a Secretary, a Manager and a Treasurer.

The President and Vice-Presidents shall be chosen from among the Directors and shall serve for a term of one year. [118]

The Secretary and the Manager and Treasurer may or may not be members of the Association and more than one may be combined and held by one person, and they shall serve at the will and pleasure of the Directors.

President

Section 2. The President shall be the executive head of the Association; he shall preside at all

Petitioner's Exhibit No. 1 (Continued)

meetings of the Association and at all meetings of the Board of Directors; he shall sign all Certificates of Membership, contracts, conveyances and all documents and agreements that the Board of Directors may by resolution require him to sign; and also the minutes of the proceedings of all meetings of the Association and of the Directors; he shall have the custody of the bonds of all the officers and employees, except his own, which shall be filed with the Secretary.

In the absence of the President, the Vice-President shall perform the duties of the President.

In the absence of both the President and the Vice-President, the Directors shall appoint a Director to act as presiding officer pro-tempore.

Secretary

Section 3. The Secretary shall keep full and complete minutes of the proceedings of the Association, and of the Directors' meetings, in a proper book; he shall countersign all Certificates of Membership, contracts, conveyances, documents and agreements and generally shall perform all duties pertaining to his office as the Board of Directors may require.

Treasurer

Section 4. The Treasurer shall be appointed by, and shall be subject to, and his duties prescribed by the Board of Directors.

Manager

Section 5. The Manager shall be appointed by, and shall be subject to, and his duties prescribed

Petitioner's Exhibit No. 1 (Continued)
by the Board of Directors; subject to the control of the Directors, he shall have direct control of the business of the Association.

Article VII

Nomination and Election of Directors

Section 1. The regular election of Directors shall [119]

be held on the regular Annual Meeting day of the Association.

Section 2. Special elections shall be held at special meetings called for that purpose.

Section 3. All elections of Directors shall be by ballot and the manner of procedure shall be as follows:

1st. On the third Monday of January of each year the Secretary shall send a list of the names of all the members of the Association residing in each District to each member of the Association residing in that District, together with a notification of the Director or Directors to be elected from that District; the Secretary shall also enclose a nomination blank upon which a member may fill in his, her or its nomination of one member for each Director to be elected, which, to be a valid nomination and entitled to be counted as such must be received by the Secretary of the Association at the general office of the Association on or before the first Thursday of February of that year.

2nd. The Director-at-Large may be elected from among members in any District, and must be nom-

Petitioner's Exhibit No. 1 (Continued)

inated by petition signed by not less than twenty-five (25) members, filed with the Secretary of the Association at least thirty (30) days prior to the date of the annual election of Directors as provided in these By-Laws.

3rd. The Directors shall, at their regular monthly meeting in January of each year, appoint a committee of three members to act as a Nominations Committee.

It shall be the duty of this committee to meet with the Directors on the first Thursday of February of each year and in the presence of the Directors, receive and count the nominations as made by the members through the medium of the nomination ballots, including the nominations for Director-at-Large as determined by the number of properly signed petitions filed with the Secretary, and shall make a correct return of the same to the Directors.

The method and manner of handling the nomination ballots shall be the same as provided elsewhere in these By-Laws for the handling of the election ballots.

4th. Upon the first Thursday of February of each year, the Board of Directors shall convene, receive from the Nominations Committee their [120] report of the result of the nominations as made by the members through the medium of the nomination ballots from each District, together with the nominations for Director-at-Large as determined by the petitions properly signed and filed with the Secre-

Petitioner's Exhibit No. 1 (Continued)

tary, and shall cause the Secretary to have printed a voting ticket for each District containing twice as many names as there shall be Directors to be elected in said District and also containing one blank space for a "write-in candidate"; the names of the nominees to be placed on these voting tickets in each District shall be those having received the highest number of votes as determined by the nominating ballots.

They shall also cause the Secretary to have printed a voting ticket to be sent to all members in all Districts containing the names of those members having been properly nominated for Director-at-Large.

These voting tickets, together with a voting envelope properly numbered to correspond to an alphabetically arranged list of all the members in each District, and addressed to the Secretary of the Association at the office of the Association, shall be mailed to each member as per his, her or its address, as it appears on the records of the Association at least ten (10) days prior to the date fixed for said election; said voting ticket and voting envelope shall show the correct number of votes to which the member receiving said voting ticket shall be entitled; complete and full instructions for voting shall accompany the ballot.

All such voting tickets properly filled out by the members to whom they were sent, and received at the office of the Association in a sealed and numbered envelope furnished by the Association for that

Petitioner's Exhibit No. 1 (Continued)

purpose, on or before the closing of the polls on said election date, shall be delivered to the Election Committee and shall be counted as the vote of the members so voting as though said member were present at the meeting.

5th. In all cases of a legal election of Directors the member or members having received the highest number of votes in the District or Districts from which elected shall be declared to be elected.

6th. At the last regular meeting of the Board of Directors prior to the Annual Election, an election committee of three members, comprising one from each District, none of whom shall [121] be Directors, also three alternates, none of whom shall be Directors, shall be appointed by the Board of Directors.

It shall be the duty of this committee to act as election officers for this election and to conduct said election, canvass the ballots cast and make due return of the result of said election; they shall take charge of all sealed ballots which have been received prior to the opening of the polls and which may be received during the election before the closing of the polls, checking same carefully against the membership list before opening and placing the ballot in the ballot box; they shall keep a complete and correct list of the names of all members voting either in person or by mailed ballot but no ballot shall be received or counted, except it be received in a sealed and numbered envelope provided by the Association for that purpose; the polls shall be

Petitioner's Exhibit No. 1 (Continued)
closed at twelve o'clock noon of the aforesaid Annual Meeting.

Immediately after the closing of the polls, the Election Committee shall proceed openly and in the presence of the Directors to count the ballots and shall make and certify a complete tally of the count, which shall be recorded in the Minute Book of the Association by the Secretary; the Election Committee shall then notify the Board of Directors of the result of the election as determined by the election ballots and shall deliver all of the records to the said Directors of the Association whose business it shall be to see that all such tally sheets and records and ballots cast shall be kept in the office of the Association for three (3) months after the date of the election; it shall further be the duty of the Directors to announce the result of the election as reported by the Election Committee and shall then openly in the meeting declare those Directors to be elected for those Districts and for those terms as shall have been determined by the Election Committee; insofar as the election of Directors is concerned, the foregoing procedure shall be final and shall constitute a legal election of Directors regardless of quorum.

Article VIII

Manner of Conducting Business

General Outline

Section 1. This Association is organized as a non-profit co-operative organization doing business with its members and with non-mem- [122] bers as

Petitioner's Exhibit No. 1 (Continued)
provided in the Articles of Incorporation of this Association.

The "Net Proceeds" shall be such funds as are derived from Overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the Directors.

The "Net Proceeds" resulting from the operation of the business, if any, shall belong to the members and shall be known as "Members' Purchase Credits" and shall be prorated to them in proportion to the amount of business each member has transacted with the Association during the period of time in which said "Members' Purchase Credits" have accumulated.

The Directors, after providing for all necessary overhead and all duly authorized reserves, are authorized to prorate and refund all of the rest of the "Members' Purchase Credits" to the members in proportion to each member's purchases from the Association during the time such "Members' Purchase Credits" shall have accumulated, all in the manner particularly set forth as follows:

Twenty-five (25) per cent thereof to be prorated and paid to the member in cash annually as soon as practical after the close of business at the end of each fiscal year and after the Auditor shall have completed the annual audit and shall have released his report to the Directors; seventy-five (75) per cent thereof to be applied to the creation and maintenance of a "Feed Finance Fund" all as provided for elsewhere in these By-Laws.

Petitioner's Exhibit No. 1 (Continued)

Feed Finance Fund

Section 2. The Directors of the Association shall create and maintain a Feed Finance Fund; this Feed Finance Fund shall be originally authorized in the sum of Sixty Thousand (\$60,000.00) Dollars and shall consist of such amounts as may be deducted from the Members' Purchase Credits as provided in these By-Laws for the creation of this fund.

Certificates bearing interest at the rate of six per cent per annum shall be issued to members representing the deductions from their Members' Purchase Credits for the creation and maintenance of said Feed Finance Fund and the retirement of the certificates thereof; said certificates shall be numbered in the order of their issuance and shall be issued in denomina- [123] tions of not less than Ten (\$10.00) Dollars and shall be issued annually commencing January 1, 1935.

From time to time, said certificates shall be retired after the aggregate value of the assets in the Feed Finance Fund thus created shall have amounted to the sum of Sixty Thousand (\$60,000.00) Dollars, or such larger sum to which the said Feed Finance Fund may be increased; said certificates shall be retired in the order in which they were issued, save and except that the Board of Directors may accelerate the retirement of any certificate for good and sufficient cause.

Members' Egg Pool

Section 3. The Directors may, if the members so

Petitioner's Exhibit No. 1 (Continued)

desire, form a pool for the handling of the members' eggs; in the handling of such pool the members are to receive the entire proceeds of sale of such eggs, less the actual cost of grading, casing, processing and transportation or brokerage or any other actual cost, either for material, labor or anything else in the way of expenses in the handling, storing or marketing of such eggs, including an amount sufficient to cover the proper portion of interest on Advance Fund Certificates and properly authorized reserves.

The Association may also deduct not to exceed one (1) cent per dozen from each dozen eggs marketed through said pool; such deductions are to be known as "Members' Egg Pool Credits" and are to be credited and applied to the creation and maintenance of an Advance Fund of the Association, or the retirement of the certificates thereof, and the Association is to issue and deliver to the members participating in such pool, Advance Fund Certificates representing such deductions, providing for interest at six (6) per cent per annum; such certificates to be issued in denominations of not less than Ten (\$10.00) Dollars and to be issued semi-annually beginning June 3, 1925.

Advance Fund

Section 4. The Directors of the Association shall create and maintain an Advance Fund; this Advance Fund shall be originally authorized in the sum of Sixty Thousand (\$60,000.00) Dollars and shall consist of such amounts as may be deducted from the

Petitioner's Exhibit No. 1 (Continued)

"Members' Egg Pool Credits," as provided in these By-Laws for the creation of this fund. [124]

Certificates bearing interest at the rate of six (6) per cent per annum shall be issued to members representing the deductions from their "Members' Egg Pool Credits" for the creation and maintenance of said Advance Fund and the retirement of the certificates thereof; said certificates shall be numbered in the order of their issuance and shall be issued in denominations of not less than Ten (\$10.00) Dollars and shall be issued semi-annually commencing June 3, 1925.

From time to time, said certificates shall be retired after the aggregate value of the assets in the Advance Fund thus created shall have amounted to the sum of Sixty Thousand (\$60,000.00) Dollars or such larger sum to which the said Advance Fund may be increased; said certificates shall be retired in the order in which they were issued, save and except that the Board of Directors may accelerate the retirement of any certificate for good and sufficient cause.

Members' Small Balances

Section 5. All balances of less than Ten (\$10.00) Dollars for which certificates may not be issued, standing to the credit of any member, either in the "Members' Purchase Credits" record or "Members' Egg Pool Credits" record shall be remitted to such members in cash, or if after proper notices shall have been sent and no reply received, then by resolution of the Directors transferred to the General

Petitioner's Exhibit No. 1 (Continued)

Fund of the Association, provided however, that such remittance in cash or such transfer to the General Fund of the Association shall not be made until after all "Feed Finance Fund" certificates and/or "Advance Fund" certificates of an even or earlier year date shall have been called for redemption to the Association, and provided further that such transfer to the General Fund of the Association shall not be made until after two (2) notices six (6) months apart shall have been sent to the member as his, her or its address shall appear on the records of the Association at date of such notice.

Funds May Be Increased

Section 6. The aggregate amount of the Feed Finance Fund and/or the Advance Fund may be increased at any meeting of the members by a majority vote of the members, providing that in the call for such meeting notice shall have been given of the amount to which [125] it shall be proposed to increase said Feed Finance Fund or Advance Fund.

Membership Fund

Section 7. All moneys received from membership fees shall constitute the Membership Fund, which fund shall not be reduced except when returned to members upon withdrawal or loss of membership as provided in these By-Laws; it may, however, be invested in lands, buildings or equipment necessary for the operation of the business of the Association, or it may be used as working capital in carrying on the business of the Association, in-

Petitioner's Exhibit No. 1 (Continued)

cluding the retirement of Feed Finance Fund certificates or Advance Fund Certificates of the Association, or in payment of small balances standing to the credit of members in the "Members' Purchase Credits" record and "Members' Egg Pool Credits" record, all as provided for elsewhere in these By-Laws, and all at the discretion of the Directors.

Reserve Fund

Section 8. There shall be reserved out of the earnings of the business of the Association each year, ten (10) per cent of the net earnings for a Reserve Fund for security of the Membership Fund; such amount shall be computed annually, deducted after all other deductions for interest, overhead and operating expenses have been made and before "Members' Purchase Credits" have been prorated.

Any moneys in this Reserve Fund or in any other Fund may be invested in property belonging to the Association, in outside securities, or used as a working capital in the operation of the business, or used in the payment and retirement of the Feed Finance Fund Certificates and/or Advance Fund Certificates of the Association, or in payment of small balances standing to the credit of members in the "Members' Purchase Credits" record and in the "Members' Egg Pool Credits" record, all as provided for elsewhere in these By-Laws and all at the discretion of the Directors.

Moneys May Be Used

Section 9. Any moneys in the Feed Finance

Petitioner's Exhibit No. 1 (Continued)

Fund or in the Advance Fund or any reserve fund may be invested in lands, buildings, equipment or anything necessary for the proper operation of the business, or it may be used as a working capital in the operation of the business of the Association, and also may be used [126] in the retirement of "Feed Finance Fund" Certificates and/or "Advance Fund" Certificates or in payment of small balances standing to the credit of members in the "Members' Purchase Credits" record or the "Members' Egg Pool Credits" record, all as provided for elsewhere in these By-Laws and all at the discretion of the Directors.

May Purchase from Members or Non-Members

Section 10. The Directors, may, if they deem it advisable and the members desire, form a pool for the handling of poultry or other agricultural products produced by the members or they may, if they deem it advisable, purchase for cash or handle on consignment poultry or other agricultural products produced by members or non-members.

In the handling of any product, whether purchased for cash or handled on consignment or through a pool or otherwise by the Association, the Directors, subject to statute and these By-Laws shall have full power of control.

Lien

Section 11. The Association shall have a first lien upon all funds, property, property rights and interests in the Association however evidenced or

Petitioner's Exhibit No. 1 (Continued)

certified, and upon any amounts payable to the members for marketing returns or otherwise, to the extent of any amount that the member may be indebted or obligated to this Association on any account or accounts, claim or claims, whatsoever, liquidated or otherwise. The Lien may be enforced through the immediate application of any cash or credit held by the Association for the member or by sale of interest or membership after ten (10) days' notice in writing served upon the member as provided in these By-Laws for service of notice of meeting. All sales of membership or interest shall be made at the office of the Association in Porterville, California, by the Secretary or other person designated by the President of the Association, without other or further formality or notice. The Association may be or become a purchaser at such sale.

Article IX

Liquidation

Section 1. If at the end of the period for which this Association is organized the members do not elect to continue the Association, or if [127] at any other period prior thereto the members shall elect to discontinue the operation of the business of the Association, the Directors with the consent of two-thirds ($\frac{2}{3}$) of the members of the Association, shall sell the assets and property of the Association, and shall apply the proceeds upon the indebtedness and liabilities of the Association in the following order of priority:

Petitioner's Exhibit No. 1 (Continued)

1st. They shall pay all indebtedness and liability of the Association other than that represented by the Feed Finance Fund, the Advance Fund and the Membership Fund.

2nd. If, thereafter, there shall be any remainder, and only in such event, they shall pay pro-rata the holders of Feed Finance Fund Certificates and Advance Fund Certificates not to exceed the face value thereof, together with all accrued interest.

3rd. If, thereafter, there shall be any remainder, and only in such event, they shall divide and pay in equal amounts to each member of the Association an amount not to exceed the face value of the Membership Certificates.

4th. If, thereafter, there shall be any remainder, and only in such event, they shall pay pro-rata to the members holding Feed Finance Fund Certificates and Advance Fund Certificates outstanding all of the balance of the assets of the Association; such payments shall be prorated to the members in accordance with the amount of purchases from the Association made by each member during the period in which such Feed Finance Fund Certificates and Advance Fund Certificates shall have accumulated.

Article X

Credits

Section 1. It shall be the aim of this Association to conduct its business as nearly as possible, consistent with best business methods, on a cash basis; all open accounts shall become due and pay-

Petitioner's Exhibit No. 1 (Continued)

able on the first of the month following the date of entry upon the books of the Association, unless by special arrangement; as a safeguard against the extension of undesirable credits, or the carrying of insecure accounts, it shall be the duty of the Directors to require an itemized statement of all accounts receivable to be rendered on the first of each month showing each account divided into thirty day, sixty day and ninety day or older amounts, which statement shall be carefully checked by them each [128] month, and they shall order the discontinuance of or the forced collections of any and all accounts deemed necessary for the safety or best interest of the Association.

Article XI

Fiscal Year

The fiscal year for this Association shall begin January 1st and end December 31st of each year.

Article XII

By-Laws May Be Amended

These By-Laws may be altered or amended at any Annual Meeting of the Association or at any other meeting of the members called for that purpose, by an affirmative vote of a majority of all the members, or the written assent of a majority of all the members shall be effectual to amend or to repeal any By-Laws or to adopt any additional By-Laws without any meeting.

[Endorsed]: U. S. B. T. A. Filed June 24, 1941.

PETITIONER'S EXHIBIT No. 3

RESOLUTION

Patronage Dividend to Members and Non-Members
Alike

Resolved, that any and all patronage dividends authorized to be paid by the San Joaquin Valley Poultry Producers Association for the year 1936 shall apply equally to members and non-members alike, and, be it further,

Resolved, that any such patronage dividend to members who joined during the year shall be made retroactive on all purchases for the full year and that such dividends to non-members shall be paid in cash or its equivalent before the closing of the books of the Association as of December 31st, 1936, and be it further,

Resolved, that the officers and employees in charge of the books and records of the Association be and are hereby authorized and instructed to carry out the provisions of this Resolution.

The above Resolution unanimously adopted on motion of Director Webb, seconded by Director Arkley this 21st day of December, 1936.

Attest.....

Secretary.

[Endorsed]: U. S. B. T. A. Filed Jun. 24,
1941. [130]

PETITIONER'S EXHIBIT No. 4

Marketing Division

RESOLUTION

Setting Up Reserve Against
Loss by Overpayment for Eggs.

Whereas, retains from proceeds of sale of members eggs, marketed by the San Joaquin Valley Poultry Producers Association, have accumulated during the year of 1936, in the amount of \$1683.56, and,

Whereas, experience has taught that it is not always possible to make final disposition of all products immediately after delivery, nor is it always possible to avoid taking some loss due to market fluctuations, deterioration, carrying charges and unexpected expenses, therefore, be it,

Resolved, that the amount of \$1683.56, be and is hereby ordered to be set up as a reserve for Protection Against Loss by Overpayment for Eggs, and be it,

Further Resolved, that the officers and employees in charge of the books and records of the Association be and are hereby authorized and instructed to carry out the provisions of this Resolution.

The above Resolution adopted at an adjourned meeting of the Board of Directors, a quorum being present, of the said San Joaquin Valley Poultry

Producers Association held this 31st day of December, 1936.

Attest.....

Secretary.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941. [131]

PETITIONER'S EXHIBIT No. 5

Purchasing Division

RESOLUTION

Patronage Dividend

Whereas, the business of the San Joaquin Valley Poultry Producers Association for the year 1936, according to the auditor's finding, shows, after deducting and setting up necessary reserves for Depreciation and Bad Debts, net overcharges of \$22,152.94, and,

Whereas, this amount is sufficient to allow for a patronage dividend of 2% of all purchases in addition to authorized necessary reserves, now, therefore be it,

Resolved, that a Patronage Dividend in the amount of \$14,214.93, shall be and is hereby declared and ordered to be pro-rated as follows: 1st: 2% of all purchases by members during said year, amounting to Eleven Thousand Seven Hundred Twenty-Five and 75/100, (\$11,725.75) Dollars to be paid to members in the usual way as authorized by the by-laws and resolution of directors.

2nd: 3½% of all purchases by non-members during said year, amounting to Two Thousand Four

Hundred Eighty-Nine and 18/100 (\$2489.18) Dollars, same being 2% of purchases plus an amount equaling in percentage the amount carried to reserves for account of members, same to be paid in cash or its equivalent to each such non-member prior to the closing of the books of the Association for the said year of 1936, and, be it further,

Resolved, that the officers and employees in charge of the books and records of the Association be and are hereby authorized and instructed to carry out the provisions of this Resolution.

The above Resolution adopted at an adjourned meeting of the Board of Directors, a quorum being present, of the said San Joaquin Valley Poultry Producers Association held this 31st day of December, 1936.

Attest.....

Secretary.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941. [132]

PETITIONER'S EXHIBIT No. 6

Purchasing Division

RESOLUTION

Setting Up Reserve for Zoning Hazard

Whereas, the Zoning Hazard still exists which prompted the setting up of a Reserve for this purpose, now, therefore be it,

Resolved, that the sum of \$5722.72, be and is hereby ordered transferred from the Operating

Account to the said Reserve for a Zoning Hazard, and, be it further,

Resolved, that the proper officers be and are hereby authorized and instructed to have the provisions of this Resolution properly executed.

The above Resolution adopted at an adjourned meeting of the Board of Directors, a quorum being present, of the said San Joaquin Valley Poultry Producers Association held this 31st day of December, 1936.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941. [133]

PETITIONER'S EXHIBIT No. 7

Purchasing Division

RESOLUTION

Reserve for Security of Membership Fund

Whereas, the business of the San Joaquin Valley Poultry Producers Association for the year 1936, after deducting Reserves for Depreciation and Bad Debts, according to the auditor's reports, shows net overcharges of \$22,152.94, and,

Whereas, the By-Laws of the said Association provide that 10% of the net earnings each year must be set aside as a Reserve for the Security of the Membership Fund before any Patronage Dividend may be pro-rated to the members, now, therefore be it,

Resolved, that the sum of \$2215.29, being 10% of such overcharges shall be transferred from the Op-

erating account in the records of the Association to the Reserve for the Security of the Membership Fund account, and, be it further

Resolved, that the officers and employees in charge of the books and records of the Association be and are hereby authorized and instructed to carry out the provisions of this Resolution.

The above Resolution adopted at an adjourned meeting of the Board of Directors, a quorum being present, of the said San Joaquin Valley Poultry Producers Association held this 31st day of December, 1936.

Attest.....

Secretary.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941. [134]

PETITIONER'S EXHIBIT No. 8

Puchasing Division
&
Marketing Division

RESOLUTION

Whereas, this association is organized and operated as a non-profit cooperative association; and

Whereas, the manner of conducting the business of the association is set forth in Article VIII of the by-laws; it being thereby provided in effect that

members and patrons shall receive for their products handled by the association the proceeds of sales thereof less costs and expenses of the association attributable to its marketing business, including deductions for authorized reserves, and that members and patrons shall be furnished with supplies at cost plus costs and expenses of the association attributable to its purchasing business, including retentions for authorized reserves; and

Whereas, it has heretofore been the practice of this association and it is the intention of this association that the individual members and patrons shall be credited on the books of the association with their pro-rata shares—i.e. in proportion to the amount of business done with the association—of any amounts retained by the association which do not represent valuation reserves or other costs and expenses of the association's doing business, and that such credits shall be paid to the members and patrons to whom credited, when, as, and if the board of directors of the association determines that the association has available funds therefor not to be needed for the use of the association;

Now, Therefore, Be It Resolved, that the accountant and auditors of this association be and they are hereby authorized and directed to determine for the year ending December 31, 1937, the amounts allocable as credits to the individual accounts of the patrons and members of this association in accordance with the foregoing, and to record such credits upon the books of the association;

Be It Further Resolved, that this association does hereby recognize the obligation to repay said credits in the manner heretofore [135] set forth.

The above Resolution adopted at an adjourned meeting of the Board of Directors, a quorum being present, of the said San Joaquin Valley Poultry Producers Association held this 31st day of December, 1937.

Attest.....

Secretary.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941. [136]

PETITIONER'S EXHIBIT No. 9

Purchasing Division

RESOLUTION

Reserve for Security of Membership Fund

Whereas, the business of the San Joaquin Valley Poultry Producers Association for the year 1937, after deducting Reserves for Depreciation and Bad Debts, according to the auditor's reports, shows net overcharges of \$26,019.01, and,

Whereas, the By-Laws of the said Association provide that 10% of the net earnings each year must be set aside as a Reserve for the Security of the Membership Fund before any Patronage Dividend

may be pro-rated to the members, now, therefore be it.

Resolved, that the sum of \$2,601.90, being 10% of such overcharges shall be transferred from the Operating Account in the records of the Association to the Reserve for the Security of the Membership Fund account, and, be it further,

Resolved, that the officers and employees in charge of the books and records of the Association be and are hereby authorized and instructed to carry out the provisions of this Resolution.

The above Resolution adopted at an adjourned meeting of the Board of Directors, a quorum being present, of the said San Joaquin Valley Poultry Producers Association held this 31st day of December, 1937.

Attest:

Secretary.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941.
[137]

PETITIONER'S EXHIBIT No. 10

Purchasing Division

RESOLUTION

Patronage Dividend

Whereas, the business of the San Joaquin Val-

ley Poultry Producers Association for the year 1937, according to the auditor's findings, shows, after deducting and setting up necessary reserves for Depreciation and Bad Debts, net overcharges of \$26,019.01, and

Whereas, this amount is sufficient to allow for a patronage dividend of 2% of all purchases in addition to authorized necessary reserves, now, therefore be it,

Resolved, that a Patronage Dividend in the amount of \$18,058.65 shall be and is hereby declared and ordered to be pro-rated as follows: 1st: 2% of all purchases by members during said year, amounting to Seventeen Thousand Nine Hundred Twenty-four and 32/100 (\$17,924.32) Dollars to be paid to members in the usual way as authorized by the by-laws and resolution of directors. 2nd: 2.87% of all purchases by non-members during said year, amounting to \$134.33, the same being 2% of purchases plus an amount equaling in percentage the amount carried to reserves for account of members, same to be paid in cash or its equivalent to each non-member prior to the closing of the books of the Association for the said year of 1937, and, be it further,

Resolved, that the officers and employees in charge of the books and records of the association be and are hereby authorized and instructed to carry out the provisions of this Resolution.

The above Resolution adopted at an adjourned meeting of the Board of directors, a quorum being present, of the Said San Joaquin Valley Poultry Producers Association held this 31st day of December, 1937.

Attest:

Secretary.

[Endorsed]: U. S. B. T. A. Jun. 24, 1941. [138]

PETITIONER'S EXHIBIT No. 11

Purchasing Division

RESOLUTION

Setting Up Reserve for Zoning Hazard

Resolved, that the sum of \$9,657.81, be and is hereby ordered transferred from the Operating Account to the Reserve for Zoning Hazard, and, be it further,

Resolved, that the proper officers be and are hereby instructed and authorized to have the provisions of this Resolution properly executed.

The above Resolution adopted at an adjourned meeting of the Board of Directors, a quorum being present, of the said San Joaquin Valley Poul-

try Producers Association held this 31st day of December, 1937.

Attest:

Secretary.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941.

[139]

PETITIONER'S EXHIBIT No. 12

San Joaquin Valley Poultry Producers Association
Porterville, California

Dear Member:

Enclosed herewith find your membership certificate, a copy of P.P.A. sales policy and a copy of P.P.A. By-Laws. Your membership entitles you to all of the benefits accruing to members of this association. Some of these benefits are:

Members' Feed Purchasing Service: Feeds and supplies are sold to all members at the same retail price in effect at time of sales. Any difference between delivered prices and actual cost of goods, plus operating expenses, belongs to the members. At the end of each year such differences, in cooperative parlance called Retains, are pro-rated to members, in proportion to their purchases as follows:

1st, each members' portion of all authorized reserves (set up for the protection of the business) is credited to him in his Members' Purchase Record and notice sent him periodically.

2nd, each member's portion of any dividends de-

clared is given to him direct, 25% in cash and 75% in an interest bearing certificate. In the Members' Purchase Record a complete record is kept, not only of all of each members purchases, but of his interest in all Retains, whether distributed in cash or certificates or whether retained for future distribution.

Egg Marketing Service. Through our egg pool we market members' eggs for them on a federally inspected and graded basis returning to them the entire proceeds of sale, less all marketing expenses. In order to do this we must have all eggs of a uniform high quality and all members must conform to the rules and regulations governing the operation of the pool. We have men specially trained in the care of eggs and, if at any time you find that your eggs do not measure up to the standard required, we will be glad to have them call on you and assist you in every way possible.

Poultry Husbandry Service. We have men specially trained to assist you in your feeding problems and anything connected with poultry husbandry. If at any time you need help in this or any other line, don't hesitate to call on us.

We certainly are glad to welcome you into our Association. We will do our best to serve you so that you too may become another of the hundreds of satisfied cooperators. The old saying that, "In unity there is strength" was never more applicable to anything than to our own little group. You are now one of us. P.P.A. business is your business now. You and the other members own it. It is

to your interest to protect it and help it as much as it is to protect your own private business on your own farm Come to the office and get acquainted The latch string is always out to you. We hope to know you better and see you often.

Yours very truly,

S. J. V. POULTRY PRODUC-
ERS ASSOCIATION,

By W. B. ROBY,

General Manager.

WBR:JR

Enc. 3.

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941.

[140]

PETITIONER'S EXHIBIT No. 13

G. BOSIACK

Security of Members		Contingencies		Zoning Hazard		Average of Eggs and Pity.	
Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
12-31-31	1.83		7.42				
12-31-32		2.70					
12-31-34	1.82						
12-31-35	3.23		.41		12.60		5.49
12-31-36	3.53				9.13		2.69
12-31-37	3.04				11.29		
12-31-38	2.29						
12-31-39	3.37						
	19.11	2.70	7.83		33.02		8.18
				1939	9.96		
					48.11		

[141]

F. C. BERTKAU

	Security of Members		Contingencies		Zoning Hazard		Average of Eggs and Pltry.	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
12-31-29		84.06		413.98				
12-31-34		10.97						
12-31-35		15.37		1.97		60.00		26.16
12-31-36		15.88				41.01		12.07
12-31-37		8.95				33.20		38.23
12-31-38		6.69						
12-31-39		14.02						
		155.94		415.95		134.21		
					1939	41.37		
						591.53		

[142]

C. J. BARTON

	Security of Members		Contingencies		Zoning Hazard		Average of Eggs and Pltry.	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
6-30-28		3.03						
12-31-28		5.33						
12-31-29		12.00		59.08				
12-31-30		18.35						
12-31-31		12.68		51.48				
12-31-32			14.85					
12-31-34		5.74						
12-31-35		10.60		1.36		41.40		18.05
12-31-36		11.72				30.27		8.91
12-31-37		11.96				44.41		
12-31-38		6.47						
12-31-39		9.04						
		106.92	14.85	111.92		116.08		26.96
					1939	26.68		
						239.83		

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941.

[143]

PETITIONER'S EXHIBIT No. 14

STATEMENT OF MEMBERSHIP EQUITY

San Joaquin Valley Poultry Producers Association

Account as of December 31, 1939

For G. BORIACK

	Your Association's Total	Your Own Total
Membership Fund Certificates....\$	10,480.00	10.00
Reserved Fund for Security of		
Membership Fund	17,362.54	19.11
Advance Fund Certificate.....	59,880.00	160.00
Members Egg Pool Credits.....	4,373.92	—
Feed Finance Fund Certificates	50,660.00	90.00
Members Purchase Credits.....	5,667.12	1.88
Revolving Fund Retain Credits	39,195.66	48.11
Total.....	\$187,619.24	329.10

[Endorsed]: U. S. B. T. A. Filed Jun. 24, 1941.

[144]

[Title of Board and Cause.]

DESIGNATION OF CONTENTS OF
RECORD ON REVIEWTo the Clerk of the United States Board of Tax
Appeals:

You Are Hereby requested to prepare, certify and transmit to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, a transcript of the record in the above cause prepared and trans-

mitted as required by law and the rules of said Court, and to include in said transcript of record the following documents or certified copies thereof, to wit:

(1) The docket entries of all proceedings before the Board of Tax Appeals.

(2) The petition before the Board with the Deficiency Notice attached and the Answer thereto.

(3) The findings of fact and the opinion of the Board.

(4) The decision of the Board.

(5) The Petition for Review filed by the Petitioner. [145]

(6) The transcript of the proceedings before said Board on June 24, 1941, together with Exhibits P-1, P-3, P-4, P-5, P-6, P-7, P-8, P-9, P-10, P-11, P-12, P-13, and P-14.

(7) This praecipe.

Dated: August —, 1942.

MILTON D. SAPIRO,
Attorney for Petitioner,
1411 Mills Tower,
San Francisco.

Approved and agreed to this 20th day of August, 1942.

J. P. WENCHEL,
Attorney for Respondent.

[Endorsed]: U. S. B. T. A. Filed Aug. 20, 1942.

[146]

CERTIFICATE OF CLERK TO
TRANSCRIPT OF RECORD

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 146, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Prae-
cipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 26th day of August, 1942.

[Seal] B. D. GAMBLE,

Clerk, United States Board of
Tax Appeals.

[Endorsed]: No. 10246. United States Circuit Court of Appeals for the Ninth Circuit. San Joaquin Valley Poultry Producers Association, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed September 12, 1942.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit
Docket No. 10246

SAN JOAQUIN VALLEY POULTRY PRODUC-
ERS ASSOCIATION, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

NOTICE OF ADOPTION OF ASSIGNMENTS
OF ERROR AND STATEMENT OF POINTS
UPON WHICH THE PETITIONER IN-
TENDS TO RELY AND DESIGNATION OF
RECORD

To the Clerk of the United States Circuit Court of
Appeals of the Ninth Circuit:

Notice Is Hereby Given that the San Joaquin
Valley Poultry Producers Association, petitioner in
the above entitled petition for review, hereby adopts
for the purposes of its appeal in the above entitled
court, the statement of points upon which the pe-
titioner intends to rely, included with the petition
for review heretofore filed with the United States
Board of Tax Appeals and said petitioner hereby
designates that the entire record certified by the
Board to the above entitled court shall be included
in the printed transcript.

MILTON D. SAPIRO,

Attorney for Petitioner.

Copy mailed Sep. 16, 1942, to J. P. Wenchel, at-
torney for respondent.

[Endorsed]: Filed Sep. 16, 1942.



11
No. 10,246

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS
ASSOCIATION,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

MILTON D. SAPIRO,

Mills Tower, San Francisco,

Attorney for Petitioner.

FILED

NOV - 5 1942

**PAUL P. O'BRIEN,
CLERK**



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No. 10,246

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS
ASSOCIATION,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

I.

STATEMENT OF JURISDICTION.

This is a petition to review a decision of the United States Board of Tax Appeals. The petitioner filed its income tax returns, showing it to have no net income for the years 1936 and 1937, with the Collector of Internal Revenue for the Northern District of California (R. p. 20). The Commissioner of Internal Revenue gave notice of a deficiency for each of those years (R. p. 10). Petitioner filed a petition for redetermination of the deficiency with the United States Board of Tax Appeals (R. p. 3). On June 19, 1942, the Board of Tax Appeals entered a decision affirming

the determination of the Commissioner and finding a deficiency in petitioner's income tax for the years 1936 and 1937 in the respective amounts of \$2261.01 and \$2047.48 (R. p. 33). A petition for review of this decision by the United States Circuit Court of Appeals for the Ninth Circuit was filed with the Board of Tax Appeals on August 13, 1942 (R. pp. 33, 40). Jurisdiction of this Circuit Court of Appeals is founded upon Sections 1141 and 1142 of the Internal Revenue Code of the United States.

II.

STATEMENT OF THE CASE PRESENTING THE QUESTIONS INVOLVED AND THE MANNER IN WHICH THEY HAVE ARISEN.

Petitioner is a non profit agricultural cooperative association organized under the non profit agricultural cooperative act of the State of California. It has no capital stock and its members are all poultry producers. It markets the poultry products of its members and also functions for them as a purchasing cooperative, supplying them with farm supplies principally poultry feed. In the years in question, 1936 and 1937, petitioner marketed eggs for its members and handled the eggs in weekly egg pools. It would return to the members the proceeds of sales, less the necessary marketing expenses on the basis of the quantity of eggs delivered by them. It handled in those years an almost negligible amount of eggs for non member producers, i e., 1.77% in 1936 and .11%

in 1937 (R. p. 78). Non members received the cash value of their eggs on delivery (R. p. 52).

In both of these years petitioner operated as a purchasing cooperative and sold supplies to its members at cost plus an overcharge estimated to cover necessary operating expenses (R. pp. 53, 54). In its supply department activities petitioner dealt with non member producers in a small way. In 1936 this non member business represented 10.47% of the total business and in 1937 it represented .52% of the total business (R. p. 78). Non members were paid patronage dividends as were the members (R. p. 135).

At the end of the year the actual costs of operation were calculated. The excess, if any, in the overcharges collected, was then prorated to the patrons, both members and non members in proportion to their patronage. The policy of the association had been established and set forth in resolutions of the Board of Directors so that patronage dividends were to be paid to members and non members alike.

The non members received their patronage dividend in cash. The members received their patronage dividend partially in cash and partially as credits and interests in certain funds established under the by-laws or by resolutions of the Board of Directors. The interest of the members in these funds was evidenced by certificates issued or a statement of credit given to individual members.

When producers joined the association, they were advised that it was the policy of the association to

retain a certain portion of these overcharges, which belonged to the members, as "RETAINS" and that such retains would be credited to them in the reserves in which they might be placed so that their individual interest would be evident for future distribution (R. p. 146). This method of retaining a portion of the overcharges belonging to the members was adopted to build up working capital. The money was retained in place of being paid over to the member and then having him return it for use in that fund. He received the same credit therefor. This was carried out under a plan whereby the amounts retained from members would revolve so that as sufficient sums accumulated in a fund to carry on the operations of the association, the amounts first retained would be paid out to those to whom the retains belonged (R. p. 75). The Board of Directors determined the time when this payment was to be made (R. pp. 72, 75).

Petitioner operated a plant in Porterville consisting of a feed mill, warehouse and sales rooms. It maintained several revolving funds in its operations. Specific amounts were appropriated for each fund from the refunds due members at the end of the year and these amounts were apportioned to the individual members in proportion to their patronage.

In 1936 a part of the overcharges determined to exist at the end of the year was retained in a fund designated as "Reserve for Zoning Hazard", which was designed to provide capital to take care of possible costs of moving the plant (R. p. 62). The individual member was credited with the specific amount that

had been retained from him for this fund and that would have otherwise been paid to him and this credit was set up on his individual ledger account in the books (R. p. 63). In addition a statement was sent him showing the amount of his credit so retained. This was done by resolution adopted by the Board of Directors. In 1936 likewise a certain portion of the overcharges which had been determined to be due to members was retained and set up in a fund designated "Reserve for Security of Membership". This fund is provided for in the by-laws (R. p. 130) and was designed to build up the general working capital of the association. The amounts placed in that fund were specifically credited to each member and he was notified thereof. Also in 1936 out of the proceeds of marketing eggs which belonged to the members, an amount was retained which was placed in a fund designated as a "Reserve against loss by overpayment for eggs". Each member producer was credited with his respective interest in this fund and it was recognized as his property (R. pp. 68-69).

In the year 1937 there was retained from the overcharges belonging to the members a portion that was placed in the reserve for Zoning Hazard and also a portion was retained and placed in the reserve for Security of Membership. In each of these instances the individual member was credited with the respective amount that would otherwise have been paid to him, the credit was set up on his ledger sheet and he was notified of that fact. All of these credits were

given after resolutions of the Board of Directors authorizing the same.

The Commissioner of Internal Revenue refused to allow the amounts so retained in these particular funds as deductions from gross income or to recognize that these amounts did not constitute net income of the petitioner. He therefore assessed a deficiency tax against petitioner in each of the years 1936 and 1937.

Petitioner filed its petition with the United States Board of Tax Appeals for a re-determination of the deficiency so assessed. The action of the Commissioner was affirmed by the Board of Tax Appeals on the ground, as it stated, that these amounts were not subject to the members' "sole command" because as it contended they could not be withdrawn at any time by the members on their demand.

The Board of Tax Appeals in making its decision failed to give recognition to the fact that the amounts retained belonged to the individual members or to the fact that a definite liability existed in favor of each member as to the respective amounts credited to him. It failed to recognize that there had been a definite appropriation of the money to the individual member and that the retention of that money was with the consent of the individual member.

Under the statutes by virtue of which petitioner is organized and under its by-laws, these monies necessarily belonged to the individual member and became his property in proportion to his patronage. When the rights of the members in these overcharges

had been declared and the respective amounts had been credited, they then accrued as obligations of the petitioner to its members as patrons. These amounts did not inure to the benefit of the petitioner or to its members as members. It was not necessary that these amounts be paid in order that their nature as obligations of petitioner be established or in order that petitioner be permitted to deduct the same from gross income. This appeal involves the question as to whether a non profit cooperative organization can so build up its working capital by contributions from its members made out of refunds otherwise payable to such members.

In its opinion and decision, the Board of Tax Appeals did not apply the law as previously set forth in decisions of the United States Circuit Courts of Appeals and other decisions of the United States Board of Tax Appeals, which decisions recognize that if the right to receive this excess arises from statute or the by-laws or by action of the Board of Directors, a liability exists which is not taxable and that amounts retained under such circumstances do not constitute net income of the association. The test used by the Board of Tax Appeals ignores the rights of members in these overcharges and refuses recognition to an indebtedness that exists.

Although it was conceded that petitioner was a cooperative association carrying on business on a non profit basis (R. p. 29) and it appeared that although it did business with non members in a small degree, such non member business was also on a non profit

basis, yet the Board of Tax Appeals failed to recognize petitioner as a non profit agricultural association entitled to establish reserves and exempt from income tax under the terms of the Income Tax Act of 1936.

As petitioner had no net income for those years and also as it was entitled to set up reserves, this appeal is taken from the decision of the Board of Tax Appeals that there are deficiencies in income tax of the petitioner for the years 1936 and 1937.

III.

SPECIFICATIONS OF ERRORS RELIED UPON IN SUPPORT OF THE APPEAL.

The contentions of petitioner are set forth in the following specifications of errors as to the acts and omissions of the Board of Tax Appeals:

(1) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of \$1683.56 which was deducted and placed in a reserve for loss by over-payment for eggs.

(2) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of \$5722.72 which was deducted and placed in a reserve for zoning hazard.

(3) The failure to allow as a deduction from petitioner's gross income in 1936 the sum of \$2215.29 which was deducted and placed in a reserve for security of membership.

(4) The failure to allow as a deduction from petitioner's gross income in 1937 the sum of \$5358.46 which was deducted and placed in a reserve for zoning hazard.

(5) The failure to allow as a deduction from petitioner's gross income in 1937 the sum of \$2601.90 which was deducted and placed in a reserve for security of membership.

(6) The failure to find that the deductions made for each of said reserve funds in the years 1936 and 1937 constituted an actual liability between petitioner and the individual producer members in proportion to their patronage and in the amounts respectively credited to each of said members in said reserve funds.

(7) The failure to find that the amounts credited in each of said reserve funds for the years 1936 and 1937 had been appropriated to the individual producers in proportion to their patronage and transferred to said funds as an addition to the working capital of the association with the assent of the said producers.

(8) The failure to find that the items disallowed were accrued as obligations of the association to the individual members.

(9) The failure to find that there was an existing liability of petitioner to each of the members in the specific amounts credited to each member in said reserve funds.

(10) The failure to find that the funds placed in these specific reserves in the respective years were credited to the individual members in proportion to their patronage and belonged to such members.

(11) The holding that there was required further corporate action by the Board of Directors of petitioner before the amounts placed in such funds belonged to said producers.

(12) The failure to find that the amounts placed in said funds constituted a liability of said petitioner to each of said producers and that the liability was created by the Board of Directors when the distribution to said funds was authorized.

(13) The failure to find that no further action of the Board of Directors was required for the purpose of creating said liability.

(14) The holding that the only deductions allowed would be limited to the amounts payable on the demand of the producers.

(15) The failure to find that the amounts placed in the (a) reserve against loss by over-payment for eggs in 1936, (b) the reserves for zoning hazard and security of membership in the years 1936 and 1937, respectively, did not constitute net income of the petitioner.

(16) The failure to find that petitioner was entitled to establish such reserves and place the respective amounts therein in the years 1936 and 1937 as a non-profit cooperative agricultural association.

(17) The failure to find that the reserves so established were reasonable reserves.

(18) The finding and holding that there were deficiencies in income tax for the calendar years of 1936 and 1937 in the respective amounts of \$2261.01 and \$2047.48 due from petitioner.

IV.

STATEMENT OF ARGUMENT.

The principal question before this court is whether those parts of the overcharges which had been credited and appropriated to the individual members in proportion to their patronage and as part of their patronage dividend and which were then retained by the petitioner in specific reserve funds constitute net income of the petitioner. It is the contention of petitioner that such amounts constitute a declared liability of the petitioner and are not taxable.

Petitioner is required to operate on a non profit basis both under the statute under which it is organized and under its own by-laws. These overcharges belonged to its members in proportion to their patronage. Its members permitted some amounts due them to remain with petitioner to be used as working capital but the retention of such amounts did not change the fact that these amounts belonged to the individual members and were not income of petitioner. They do not constitute net income. If included in gross income, petitioner was entitled to deduct such amounts from gross income.

Also, as petitioner is a non profit cooperative agricultural association engaged in marketing the agricultural products of its members and returning to them the proceeds less necessary marketing expenses and in turning over supplies and equipment at cost plus necessary expenses, it is entitled to establish reserves and the amounts placed in such reserves would not constitute net income.

A. THE STATUTE UNDER WHICH PETITIONER EXISTS AND THE BY-LAWS OF PETITIONER REQUIRE IT TO OPERATE ON A NON PROFIT BASIS SO THAT THE AMOUNTS INVOLVED BELONG TO THE MEMBER PRODUCERS AND ARE NOT NET INCOME OF THE PETITIONER.

Petitioner was organized under the Agricultural Non Profit Cooperative Marketing Association Act of the State of California (Now secs. 1191-1221 Agricultural Code of the State of California). Sec. 1192 of that code reads, "Associations organized hereunder shall be deemed 'non profit' inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers.

The Articles of Incorporation of petitioner provide that it shall be a non profit cooperative association (R. p. 93). The Articles further provide that "this association shall conduct and carry on its business without profit to itself, and shall not make, declare or pay to its members any dividend on membership certificates" (R. p. 95).

In Section 1, of Article VIII (R. p. 124) the by-laws carry on this recognition of its non profit nature and provide as follows:

“ARTICLE VIII.

Manner of Conducting Business
General Outline

Section 1. This Association is organized as a non-profit co-operative organization doing business with its members and with non-members as provided in the Articles of Incorporation of this Association.

The ‘Net Proceeds’ shall be such funds as are derived from Overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the Directors.

The ‘Net Proceeds’ resulting from the operation of the business, if any, shall belong to the members and shall be known as ‘Members’ Purchase Credits’ and shall be prorated to them in proportion to the amount of business each member has transacted with the Association during the period of time in which said ‘Members’ Purchase Credits’ have accumulated.”

The by-laws constitute a contract between the association and its members.

Riverside Land Company v. Jarvis, 174 Cal.
316, 163 Pacific 54, 59.

Under the provision set forth, the net proceeds, as so defined in the by-laws, become the property of the members and belong to the members whether paid to

them or retained by the petitioner for subsequent disposition. Since these funds belonged to the producers, they did not represent income of petitioner.

The courts of California have held that under this provision of the Agricultural Code, associations organized thereunder are not permitted to make profits for themselves and that withholdings representing funds similar to those involved in this proceeding belong to the producers. These decisions hold that the producers have a property interest in such funds even though they are retained by the association and paid out on a revolving fund basis.

Bogardus v. Santa Ana Walnut Growers Association, 41 Cal. App. (2d) 939, 947, 108 Pac. (2d) 52;

Loomis Fruit Growers Association v. California Fruit Exchange, 128 Cal. App. 265, 280, 16 Pacific (2d) 1040,

wherein the court states:

“The Buford case need not be considered further than simply supporting what we have said, that the withholdings made by the Exchange were of moneys belonging to the Association and to the growers marketing fruit through the Exchange.”

The Board of Directors recognized this legal and contract obligation when they provided for the credits to be given to the individual members as to any amounts retained by petitioner. They were set up as an accrued liability of petitioner to them and were not “income” of the petitioner.

B. THE AMOUNTS RETAINED BY PETITIONER AND PLACED IN THE RESPECTIVE FUNDS DID NOT CONSTITUTE NET INCOME OF PETITIONER AND WERE PROPER DEDUCTIONS FROM THE GROSS INCOME OF PETITIONER.

At the end of each of the respective years, the Board of Directors of petitioner determined the amount of overcharges available and adopted a series of resolutions so as to appropriate these sums for the individual producer in proportion to his patronage. This was in express recognition of the fact that they belonged to the producers and were not income of petitioner.

In 1936 the directors declared the express policy that patronage dividends would apply equally to members and non members alike (Ex. 3, R. p. 135). Then on December 31, 1936 the Board of Directors of petitioner adopted a series of resolutions setting up the patronage dividends and retaining a portion of the amounts belonging to members in the specific funds involved in this appeal (Ex. 4, 5, 6, and 7, R. pp. 136-139).

The resolution on patronage dividend provided that members would receive a patronage dividend of 2% of their purchases, plus the amount carried to the reserves for the account of the respective members. Non members received $3\frac{1}{2}\%$ of their purchases, in cash, which was the equivalent of 2% and the amount carried to the reserves for members. The amounts so placed in these reserve funds were part of the patronage dividend of the members. These amounts were considered as patronage dividends and treated as such (R. p. 88). The resolutions as to patronage dividend and allocating the amounts to these reserve funds were

all adopted at the same meeting. When the amounts were so prorated they were immediately entered upon the books and credit was given to the individual producer in his account for the amount retained from his patronage dividends. Then a statement was sent to him showing such credit (R. p. 81). An exemplar of these statements is contained in the records (Ex. 13, R. p. 148). Also a statement was sent to him at the end of each year (Ex. 14, R. p. 150) showing his established interest in all funds.

In 1937 a generally similar set of resolutions was adopted (Ex. 8, 9, 10, 11, R. pp. 140-146). At the meeting of December 31, 1937 a series of resolutions provided for the patronage dividend and the disposal of the amounts determined as the interest of the respective members and non members therein. One resolution specifically reaffirmed the manner of handling amounts retained for these respective funds and reaffirmed the fact that they were an obligation of the association (Ex. 8, R. p. 148). The resolution as to patronage dividend provided for 2.87% of purchases by non members to be paid as a dividend and for a dividend of 2% of the purchases of members plus the amount carried to the reserves for the account of members. This equalized the patronage dividend between members and non members (Ex. 10, R. p. 144).

When a member entered this association he was advised of its policy in retaining a portion of the patronage dividend which would thus belong to him. He received a letter from the association in which, among other information, the following was contained:

“* * * Any difference between delivered prices and actual cost of goods, plus operating expenses, belongs to the members. At the end of each year such differences, in cooperative parlance called Retains, are pro-rated to members in proportion to their purchases as follows:

1st, each member's portion of all authorized reserves (set up for the protection of the business) is credited to him in his Members' Purchase Record and notice sent him periodically.

2nd, each member's portion of any dividends declared is given to him direct, 25% in cash and 75% in an interest bearing certificate. In the Members' Purchase Record a complete record is kept, not only of all of each member's purchases, but of his interest in all Retains, whether distributed in cash or certificates or whether retained for future distribution.” (Ex. 12, R. p. 146.)

All of these acts on the part of petitioner and its Board of Directors constituted acknowledgment that the amounts concerned belonged to the individual members to whom they were specifically credited. The by-laws provided that they so belonged, the Board of Directors specifically appropriated these amounts to the individual members as their property and the authorized officers of the association set up the proper credits therefor. It is undisputed that the credits were set up and that the interest of the individual members in these funds was fixed on the books (R. p. 71).

These funds were set up to be operated on the revolving fund basis (R. p. 74). It was necessary to

accumulate money in this manner or the association would have had to borrow it from outside sources (R. p. 72). Securing it this way, the members themselves retained control of the financial structure of the association and the funds used as working capital. This, cooperative authorities regard as the most consistent and reliable source of capital revenue (see Evans & Stokdyk, *The Law of Cooperative Marketing*, pp. 164, 174). As the funds were built up, and at a time determined by the directors, they would start to revolve so that through deductions or retains from the later participation, the first contributions would be retired (R. p. 75). Thus the capital of the cooperative is maintained by those actually using it.

When the Board of Directors had acted in determining the amount of the overcharge and their action had been carried into effect by the placing of credits on the books in the name of the individual member, the liability of petitioner had definitely accrued and an indebtedness to the producer was created. Nothing further was required to be done by the Board of Directors to establish that liability. This indebtedness could not be classified as income and was not taxable.

Union Printing and Supply Company v. Commissioner of Internal Revenue, 88 Fed. (2d) 75.

A case setting forth the principles under which this appeal should be determined is *Cooperative Power Plant v. Commissioner of Internal Revenue*, 42 B.T.A. 120, wherein overcharges for services had been purposely made to build up a fund to construct a new

power plant. The Board in determining that such overcharges were not income, recognized that gain was not an object of the cooperative arrangement and that this overcharge did not constitute gain for more than bookkeeping purposes. It held that the amounts represented indebtedness and therefore a liability and could not be taxed as income. Here also the overcharges represented an indebtedness and a liability to the individual producers. Gain was not an objective of this particular cooperative and there was no gain subject to taxation.

Likewise in *Valley Waste Disposal Company v. Commissioner of Internal Revenue*, 38 B.T.A. 452, 457, a similar ruling was made as to the funds collected which were not expended during the taxable year. The Board said:

“Even though it might, for bookkeeping purposes be labeled ‘surplus’, it really represented an indebtedness to its members, or pay in advance for services to be rendered during a later year. It was, in no sense gains, profits, and income as such terms have been defined in *Eisner v. Macomber*, 252 U. S. 189, and kindred cases. At best it was a mere accumulation, paid in by the members, to be used for the purpose of disposing of the waste or to be returned to them upon dissolution. As was said by this Board in a case somewhat analogous—*Growers Cold Storage Co.*, 17 B.T.A. 1279—the surplus overassessment ‘was really an indebtedness or refund due the members and was a liability and not taxable’.”

C. THE RETENTION BY PETITIONER OF A PORTION OF THE PATRONAGE DIVIDENDS WHICH HAD BEEN CREDITED TO THE INDIVIDUAL PRODUCER, AND THE USE OF THE SAME AS WORKING CAPITAL, DOES NOT MAKE IT A PART OF GROSS INCOME AND THEREFORE SUBJECT TO INCOME TAX.

The practice of petitioner in so treating and retaining the amounts due members at the end of a year is one common to many cooperative associations. They recognize that the overcharges on hand belong to the producers, they apportion the amounts to them but instead of making payment in cash, the amounts are reserved for working capital and the account of the individual member is specifically credited with his interest in the fund. The producers thereby build up slowly the necessary financial background for their cooperative. Tax authorities have recognized these practices of cooperatives designed to secure support from their own members and have held that these deferred payments were not income to the corporation.

S.M. 2288, C.B. III-2, p. 233, covered a cooperative that had set aside part of its savings in a reserve to finance its operation during the unremunerative part of the succeeding season. It was recognized that the amount so retained remained as a credit to the purchasers in proportion to their patronage and that payment was merely held in abeyance. It was ruled that this amount would not inure to the benefit of stockholders as such and would not affect its exemption from taxation. Again in S.M. 2286, C.B. III-2, p. 236, where part of the proceeds had been held with the consent of the growers to meet possible emergencies, it was recognized that the reserves would ultimately

revert to the growers to whom it essentially belonged and that such amount was not subject to tax as income.

In an office decision of the Income Tax Unit, this subject is discussed. In I.T. 3208, C.B. 1938-2, p. 127, an Iowa cooperative made additions to certain funds and credited the account of the members in proportion to business done with the association. Certificates were issued for these amounts which were handled on a revolving fund basis. In effect, the patrons took stock of the corporation in lieu of usual patronage dividends. In this decision, it is said:

“This office is of the opinion that there is a distinction between the patronage dividends here involved and the payments ordinarily termed ‘patronage dividends’. However, like ordinary patronage dividends, these in the present case do not represent gross income of the corporation.
* * * As such credits represent contributions for capital stock, the amount thereof is not income to the corporation but the value thereof is income to the patrons credited. That is a patron member of one of the instant corporation agrees to buy or sell through the corporation with the understanding that in addition to the fixed consideration passing at the time of the transaction, his proportionate share of the proceeds of the corporation over its statutory operating expenses shall be credited to his capital account with the corporation.”

Ours is a generally similar situation. Members, when they became such, knew that part of their share of net proceeds would be retained in authorized working capital funds and they would be credited therein with

their respective amounts. Owing to the fact that petitioner is a non-stock corporation, no stock was issued but the statement (Ex. 14, R. p. 150) sent out was more definite as to the interest of the member in such funds than any stock certificate might be.

In *Farmers Union Coop. Assn. v. Commissioner of Internal Revenue*, 13 B.T.A. 969, the cooperative provided for the issuance of stock in liquidation of credits credited to the accounts of its members as their proportion of the net overcharges determined at the end of the year. The Commissioner contended that this was a stock dividend; that it did not represent a liability to patrons; and that the amount in controversy was not paid. The Board of Tax Appeals held that under its by-laws which were a contract with its members, petitioner was liable to them for the full amount of its net operating income and that since the books showed the amounts distributable this was a liability at the close of the year. Therefore the Board held that this amount was erroneously included in taxable income. The Board also held that the issuance of stock was not a stock dividend as a distribution of corporate assets but was in discharge of a recognized liability of the petitioner. It therefore set aside the determination of the Commissioner as to a deficiency.

Under the by-laws of this petitioner, the amounts placed in the reserve funds in question represented a liability of petitioner to its members. Petitioner recognized that liability and set up on the books a credit to the individual member. This then was no part of taxable income. Certainly if the member had

been paid in cash and had then paid the sums into the association as working capital, that would not be income. Neither can the retention of the funds be regarded as the receipt of income. Surely the law would not compel a cooperative to go through this unnecessary expense of distribution and collection and will not penalize it by causing it to lose its right to deduct existing liabilities from gross income because it has not done so.

D. THE FACT THAT THE PATRONAGE DIVIDEND IS NOT PAID IN CASH DOES NOT AFFECT THE RIGHT OF PETITIONER TO EXCLUDE IT FROM GROSS INCOME.

The decided cases evidence the accepted rule that payment is not the test of deductibility and that non-payment, where the liability is created by the by-laws or acts of the association and the credit to the individual appears, is completely immaterial.

Where we find, as here, that there has been a definite act of appropriation to the credit of the individual, then such amounts are deductible from gross income as an indebtedness has been created and they are no part of taxable income.

In *Anomosa Farmers Creamery Co. v. Commissioner of Internal Revenue*, 13 B.T.A. 907, petitioner, a creamery cooperative, determined its net operating income at the end of the year, prorated it and credited it to each patron in proportion to their deliveries. The Board held that this amount should not be included in gross income and that the fact that cash was not paid to the patrons in the taxable year was not material.

In *Home Builders Shipping Association v. Commissioner of Internal Revenue*, 8 B.T.A. 903, a further amount due stockholders had been determined but had not been paid. The Commissioner disallowed the amount because it had not been declared, accrued or paid and was eventually wiped out by operating losses. The Board stated "It is to our minds immaterial that the liability of \$4137.70 has not, as yet, been paid." It held that there was an actual liability, set upon the balance sheet as being due to its stockholders and that therefore it should be treated as part of the cost of wheat sold. In the instant situation, petitioner had declared the amounts in question accrued and had set them up to the credit of the individual member. They appeared as a liability on the books of the corporation and the fact that they were not paid in cash would therefore be immaterial.

The Commissioner's office has acknowledged that the exempt status of a cooperative organization is not affected by the deferment of payment of patronage dividends to non members as long as the association keeps records thereof and sets up a specific credit to the individual account of each non member. (Mim. 3886, C.B. X-2 pp. 164, 166, I.T. 2791, XIII 1-77). Such amounts are not then regarded as income to the association. Surely then if members have been specifically credited with the amounts appropriated to them, such amounts cannot be taken as income of the petitioner.

E. THE FACT THAT THESE FUNDS ARE PLACED IN USE DOES NOT AFFECT OR CHANGE THEIR CHARACTER.

Respondent, before the Board of Tax Appeals, made the contention that because the monies in these funds were used by petitioner in its operation, it was not entitled to deduct the same from gross income. The use of these funds is no test as to whether the funds constitute taxable income.

The funds retained by petitioner are used in its operations. They may be used to supply equipment, finance marketing, purchase supplies or provide buildings and equipment. This is what they were intended for. However, the use of these funds does not change nor interfere with the existing liability or obligation to the member patron (R. p. 74). Once that obligation has been established, it remains as a liability until the member is paid.

The purpose for which the member permits the petitioner to retain his money is to furnish petitioner with working capital. This means that it will be employed in the operations of the association. It is not expected that it will be held in cash. However, at the time it is placed in these funds, it is the property of the member being turned into a working capital fund with his consent and approval. Later it will be revolved out and returned to him as other member patrons permit their funds to be retained and used for like purpose.

The fact that the sums so received by petitioner are subject to use by it does not make these funds income any more than the receipt by a corporation of the proceeds of stock sold to its stockholders is income be-

cause such monies are used for the purposes of the corporation. It is simply working capital which is no part of gross income and not subject to tax as income.

F. THE BOARD OF TAX APPEALS HAS FAILED TO APPLY CORRECTLY THE LAW APPLICABLE TO THESE FACTS AND HAS ATTEMPTED TO SET UP AN ERRONEOUS AND UNAUTHORIZED TEST BEFORE RECOGNIZING A PRESENT INDEBTEDNESS.

In its decision the Board of Tax Appeals has quoted three cases to support its finding. However the Board has failed to follow the language and reasoning of the cases and has disregarded the actual facts of this case.

In *Fruit Growers Supply Company v. Commissioner of Internal Revenue*, 21 B.T.A. 315, affirmed 56 Fed. (2d) 90 (C.C.A. 9), this court only took the position that until patronage dividends were declared they would not accrue as obligations. In that case there had been no deductions or declarations on the part of the Board of Directors or the corporation in reference to the overcharges. Here specific provision for credit was made by resolution of the Board of Directors, an entry was placed on the individual's ledger account and a statement sent to him, so that the liability definitely accrued.

In *Farmers Union Cooperative Company v. Commissioner of Internal Revenue*, 90 Fed. (2d) 488, no action had been taken by the company as to the balance held by it. The court ruled that the right of ownership of the individual producer would not accrue until a patronage dividend had been declared. It did

not require that it would have to be paid. That court recognized that its decision might have been different if, as with this petitioner, the articles or by-laws of the association concerned had contained provisions requiring such apportionment to members. The court said :

“As stated above, if petitioner had been organized and operated on a purely co-operative basis where all annual net earnings were apportioned to all of the patrons during the year, there might be here a more serious question as to whether such earnings constituted ‘income’ within the Amendment.” (492)

The Board also cited a recent decision of this Circuit Court, *Cooperative Oil Association v. Commissioner of Internal Revenue*, 115 Fed. (2d) 666, but made no comment on the same. An examination of that opinion shows that it does not apply to this appeal. In that case there was no provision in the articles or by-laws showing that the net proceeds belonged to members, nor was there any active appropriation of the amounts in question to the individual producer. No resolution was adopted by the Board of Directors as was done here, nor was any entry made on the records. Therefore the Board and this court held that lacking that appropriation, no liability had been created. No one of those cases support the ruling of the Board as to the facts of this proceeding.

The Board attempts to set up a new test of liability and to build their decision on two words used by the late Justice Holmes in *Corless v. Bowers*, 281 U. S. 376, 74 Law. Ed. 916 wherein he used the expression

“unfettered command”. The Board endeavors to imply that only if the producer had the right to payment on demand could these amounts be recorded as a liability and therefore not income. Certainly such logic violates all reasoning. Liability can still exist whether an indebtedness is payable on demand, at a certain date in the future or even at a future date not yet certain. The obligation constitutes an indebtedness even though the money is not immediately payable.

Nelson v. Wilson, 264 Pac. 679, 683, 81 Mont. 560.

If the Board had followed the spirit of the decision of Judge Holmes in that case, it would have found for the petitioner. He there said, “Taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid.” Here the benefit that accrues is to the producer. He has acquired additional property by reason of his right to a proportionate interest in the overcharge. It either lessens the cost of his operation or gives him in the case of his marketing pools an additional amount of net proceeds. This involves his individual income and he is the beneficiary. It is his income that must be taxed. Information as to his gain is given to him in the form of an acknowledgment of the credit owing to him. It is upon his command and consent that the funds are used as working capital by the petitioner for the association is controlled by its producer members. Even following the language of Judge Holmes, the credits here involved were subject to the “unfet-

tered command'' of the producers and did not constitute income of the petitioner. That command is not lost because the member assents to the retention of the amounts which are to be paid to him. The assent to such use upon his becoming a member is an exercise of that command.

The Board in a very recent case, also involving 1936 and 1937 income taxes, *Midland Cooperative Wholesale v. Commissioner of Internal Revenue*, 44 B.T.A. 824, held that the retention of amounts placed in reserves represented a liability of the association and that the amounts so placed in reserves were deductible from gross income. In that case, part of the patronage dividend was paid in cash and part was placed in an equity reserve account. Each patron was notified, as in this case, of the amount of his credit in that reserve account. There was no specific time at which he would be paid. The Commissioner refused to allow as deductions the amounts so credited which were left in the association as working capital. The Board in reversing this ruling, recognized that the undivided surplus belonged to the patrons and was required to be distributed to them annually on the basis of patronage. It recognized that these amounts were in reality rebates upon the business transacted by the association with its members rather than true income of the association. It also recognized that the association could set aside a portion of the amount in a reserve account since there was no prohibition of law against it. The Board then considered the question as to whether there was a liability to pay the members and said in that regard:

“The next question is whether additional corporate action is required to be taken before petitioner becomes under a definite liability to pay to its members the amounts set aside to their credit. Petitioner points out that the amounts to be paid forthwith to its members in cash and the amounts to be held in reserve were both authorized at the same time and by the adoption of one resolution; that both were allocated to the members at the same time and entered upon the corporate ledger as credits; and that both were computed upon the business transacted with the association. It argues, therefore, that both were properly accrued as liabilities upon its books. We agree with petitioner. In our opinion all necessary steps were taken in the taxable years to obligate petitioner to pay the earnings over to its members. The resolutions of the Board of Directors recognized that the entire amounts—\$53,601 in 1936 and \$58,673.43 in 1937—belonged to the members. The statutes and the by-laws so provide. If any other disposition of such earnings had been made—other than putting them in permanent surplus—the directors would have committed an unlawful act, which under the statutes of Minnesota would have been ‘cause for the cancellation of the charter’. The amounts in question were not put in permanent surplus. They were allocated to the members, though held in reserve.”

The facts of that case are practically on all fours with the facts of this proceeding. The amounts to be paid members and the amounts to be held in reserve by petitioner were both authorized at the same time and by the same series of resolutions. These amounts were

all set up in the ledgers as credits at the same time and both were proportionately computed upon the business transacted with petitioner. Also as in that case, no additional action was required to create the liability and the producers would clearly be general creditors of petitioner if the association was liquidated before they were paid (By-laws, Art. IX, R. p. 133).

The Board has attempted to differentiate the *Midland* case by suggesting that the amounts so payable could have been withdrawn at any time. However the facts of the case as set forth in the Board's opinion, show no difference. In its statement of facts, page 830, the Board says:

“At the time of the hearing most of the amounts which had been credited by petitioner to its members in connection with the patrons' equity reserve were still held by it. In 1939 one of its members was liquidated and 1940 one was placed in receivership. *In each instance request was made that petitioner apply the amount which had been credited to the member against its indebtedness to petitioner. This was done after approval by petitioner's board of directors.* In the first instance petitioner was thus enabled to collect \$1.06 and in the second, \$91.99. The remaining amounts credited to the members as shown above are still held by petitioner.” (Italics ours.)

It must be noted that the application of these amounts against the indebtedness due from the member was only made after approval by the Board of Directors. The liability of the association to the pro-

ducer existed at all times as here, but in order to apply the credit, it was necessary that the Board of Directors of that association act.

Under the by-laws of this association, Article VIII, section 11 (R. p. 131), the association retains a lien against the interest of the members for any indebtedness due the association and the credits held may be applied to reduce such indebtedness. Certainly if a member was liquidating or was in receivership, the Board of Directors of this petitioner would have authorized the application of credits due him against indebtedness due the association and thus have secured payment of such indebtedness. What Board of Directors would not so approve under such circumstances? There is no distinction between the cases and this petitioner is entitled, on the basis of the *Midland Cooperative Wholesale* case, to have the decision of the Board of Tax Appeals reversed.

The Board of Tax Appeals has, by its opinion in this case, narrowed and restricted the exemption which Congress gave to these cooperative marketing associations. Congress has consistently fostered and encouraged cooperatives since the enactment of the Clayton Act in 1914 (15 U.S.C., Sec. 17).

Liberty Warehouse Company v. Burley Tobacco Growers Assciaton, 276 U. S. 71, 93, 72 Law. Ed. 473, 481.

From the early days of the Federal Income Tax, it has been recognized that true cooperatives such as petitioner have no net income and they have been accorded exemption from such tax (1916 Income Tax

Law, Sec. 11, 39 Stat. L. 771). The Treasury Department gave to these acts the liberal construction intended by Congress. This intent was well known and has been recognized by the Board of Tax Appeals itself.

Eugene Fruit Growers Association v. Commissioner of Internal Revenue, 37 B.T.A. 993, 1003.

In *Farmers Co-operative Creamery v. Commissioner of Internal Revenue*, 21 B.T.A. 265, 267, the Board in discussing the effect of the Revenue Act of 1926, wherein Congress first provided by statutory legislation for reserves for cooperatives and for their right to do business with non members, said:

“That this action by Congress did not change the existing law but was designed solely to prevent a possible narrowing thereof by administrative construction fully appears in the Conference Report of the Congressional Committee at page 37, wherein it is stated: ‘* * * This amendment does not broaden the scope nor even include all of the provisions of the Treasury regulations, but only incorporates certain provisions adopted by the department as fundamental in allowing exemptions to cooperative marketing and purchasing associations. The amendment assures such associations, now exempt, that the liberal construction by the department of existing law is sanctioned by Congress, and will prevent a restriction upon the present exemptions, such as is now possible under existing law.’

“An almost identical statement appears in the report of the Committee on Finance of the Senate.

“From the foregoing it is apparent that Congress looked with entire favor on the broad construction given to the Revenue Act of 1924 and that Regulations 65 truly reflected the Congressional intent.”

The decision in this case tends to defeat that intent. It imposes a restriction never intended to be applied, one that would hamper and defeat the ability of cooperatives to build up their working capital by contributions from their own members. Taxing of this working capital so obtained, is completely contrary to the intent of Congress to prevent restrictions upon present exemptions.

G. PETITIONER, AS A NON-PROFIT COOPERATIVE AGRICULTURAL ASSOCIATION WAS ENTITLED TO BE CLASSIFIED AS AN EXEMPT CORPORATION AND WAS ENTITLED TO ESTABLISH REASONABLE RESERVES FOR ANY PURPOSE AND THE AMOUNTS PLACED IN THESE RESERVES IN 1936 AND 1937 DID NOT CONSTITUTE NET INCOME.

Section 101 (12) of the Revenue Act of 1936 (49 Stat. L. 1648) provided as to exempt corporations as follows:

“(12) Farmers’, fruit growers’ or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of

members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses * * * nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of non members in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for non members in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph."

In the petition filed in this proceeding, petitioner specifically set forth that the Commissioner had failed to give recognition to the cooperative nature of this association (R. p. 7). This was one of the grounds relied on to show that the Commissioner erred in including as net income the amounts referred to in this proceeding.

The evidence clearly and conclusively establishes the non-profit cooperative nature of petitioner and its exempt status.

By its charter from the State of California as contained in its Articles of Incorporation (R. p. 92), petitioner is required to carry on its business without

profit to itself and cannot declare any dividends on membership certificates (R. p. 95). This it has carried out in its operations. It operated without profit to itself or to its members as such. It did business at cost for its producer patrons.

In marketing agricultural products for its members, it turned back to them the proceeds less necessary selling expenses. In providing them supplies, it did so on the basis of cost plus necessary expenses, equalizing the matter of expenses by refunds provided for at the end of the year, as is the recognized procedure of such associations.

Petitioner carried on some dealings with non members. These dealings were slight in 1936 and almost negligible in 1937, being much less than one per cent of the total business. However it paid patronage dividends to non members as it did to members. The directors recognized and directed that members and non members were to be treated alike (R. p. 135) and the record shows such equitable treatment to have been given (R. pp. 137, 143).

There can be no question as to the reasonableness of these reserves as to amount or purpose. In the first place, it must be the intent of the act that such question be first addressed to the discretion of the Board of Directors, the administrative body of a cooperative marketing association. Secondly, the evidence establishes the necessity and shows the amount of the particular reserve funds involved to be reasonable.

Petitioner's annual business amounted to close to \$2,000,000 (R. p. 77) and the sums set aside for these

reserves can readily be seen to be reasonable for such a marketing and supply activity and to maintain its mill, warehouse and selling office.

The reserve for Zoning Hazard was necessary to provide capital that might be required for a possible sudden change in the location or set up of the association's plant (R. p. 62). The prospect of such need was imminent. It was not only a reasonable but a most prudent exercise of judgment to provide necessary working capital through a building fund so as to insure the uninterrupted operation of the activities of petitioner for the benefit of its producer members.

Eugene Fruit Growers Association v. Commissioner of Internal Revenue, 37 B.T.A. 993, 998.

The amounts determined as reasonable and necessary by the Board of Directors constituted about one-third of one per cent of the business done.

The reserve against loss by overpayment for eggs was a caution taken by the Board of Directors in 1936 (R. p. 69). This was a reasonable precaution to provide funds to cover such a contingency and the amount of \$1683.56 set up to protect an egg volume of \$727,-979.01 was on its face reasonable.

The reserve for Security of Members is provided for in the by-laws (R. p. 130) and was intended and used to build up working capital to meet the expected growth of the association. Its purpose is essential and reasonable. Its amount (ten per cent of net overcharge, or about one-seventh of one per cent of business done) is clearly reasonable, considering the needs of the association, as is evident from the record.

Since this petitioner operated as a non-profit agricultural cooperative marketing and purchasing association, its right to accumulate and have these reserves is clearly acknowledged by the Income Tax Act. It should have been recognized as an exempt corporation with a clear right to set up or add to its reserves. That right is not defeated by the fact that it unequivocally recognizes the rights of its members to the sums placed in these reserves and that these sums belonged to them so as to create an obligation of the association towards them.

V.

CONCLUSION.

Petitioner respectfully submits that it had no net income in the years 1936 and 1937. The amounts set aside in these particular reserve funds represented an accrued liability of the petitioner to its members. These amounts belonged to the members and had been appropriated and specifically credited to each of them in proportion to their patronage. They did not constitute net income of the petitioner and should not have been so classified by the Commissioner or the Board of Tax Appeals. Further, petitioner was an exempt corporation and as such entitled to place these funds in its reserves.

It is respectfully submitted that the decision of the Board of Tax Appeals should be reversed.

Dated, San Francisco,
November 4, 1942.

MILTON D. SAPIRO,
Attorney for Petitioner.

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No. 10246

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

**SAN JOAQUIN VALLEY POULTRY PRODUCERS ASSOCIATION,
PETITIONER**

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS*

BRIEF FOR THE RESPONDENT

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FILED

DEC 1942

**PAUL P. O'BRIEN,
CLERK**



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BRIEF FOR THE RESPONDENT

OPINION BELOW

The memorandum opinion of the Board of Tax Appeals (R. 19-32) is unreported.

JURISDICTION

This petition for review (R. 33-40) involves federal income taxes for the calendar years 1936 and 1937 (R. 3-4, 10-11). On April 8, 1940, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiency in the total amount of \$4,308.49. (R. 10-17.) Within 90 days thereafter and on June 17, 1940, the taxpayer filed with the Board of Tax Appeals a petition for redetermination of deficiency (R. 3-17) under the provisions of Section 272 of the Internal Revenue Code. The decision of the Board of Tax Appeals sustaining

the deficiency was entered on June 19, 1942. (R. 33.) The case is brought to this Court by a petition for review filed August 13, 1942 (R. 40), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the taxpayer, a cooperative association organized under the Agricultural Code of California, is entitled to deduct from gross income for the taxable years amounts retained by it and credited to certain reserve funds, where allocable portions of the amounts so retained were credited to the accounts of its members on a patronage basis.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 27-31.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 20-28) may be summarized as follows:

The taxpayer is a cooperative association organized under the laws of California, with its principal place of business in Porterville, Tulare County. It filed its income tax returns for the years 1936 and 1937 with the Collector of Internal Revenue for the Northern District of California. (R. 20.)

The members of the taxpayer are poultry producers. Membership is acquired by the payment of a \$10 fee, as provided in the by-laws, which, with the articles of incorporation, are in evidence and incorporated by

reference in the Board's findings. The taxpayer maintains at Porterville, California, a feed mill, warehouse, and an office. (R. 20.) Its business consists of (1) a "Marketing Division" for the marketing of poultry and eggs for producers, and (2) a "Purchasing Division" for the sale of feed and other farm supplies to poultry producers. (R. 21, 93-95, 101-102, 124-132, Pet. Ex. 1.) During the years 1936 and 1937, the taxpayer marketed its eggs in weekly pools and made payments to the members participating in the pools on the basis of the number of eggs marketed by the taxpayer for each member. The payments to members were determined by the quotations on the Los Angeles market less estimated expenses. The taxpayer also marketed eggs for nonmembers during the years 1936 and 1937, but the nonmembers did not participate in the pools. Eggs obtained from nonmembers were treated as cash purchases for resale. During the years 1936 and 1937, the taxpayer made sales of feed and other farm supplies to both members and nonmembers. (R. 21.) The prices at which such supplies were sold to members were based on direct cost to the taxpayer, plus overhead expenses, the prices fixed being slightly above such expenses so that there would be no danger of loss to the taxpayer. (R. 21, 146-148, Pet. Ex. 12.)

Article VIII of the taxpayer's bylaws provides, in Section 1, that "Net Proceeds" shall be such funds as the taxpayer derives from overcharges on purchases made by both members and nonmembers. These net proceeds of the "Purchasing Division", according to the bylaws, shall belong to the members and shall be

known as "Members' Purchase Credits." (R. 25.) Disposition of the members' purchase credits is provided for as follows (R. 125):

The Directors, after providing for all necessary overhead and all duly authorized reserves, are authorized to prorate and refund all of the rest of the "Members' Purchase Credits" to the members in proportion to each member's purchases from the Association during the time such "Members' Purchase Credits" shall have accumulated, all in the manner particularly set forth as follows:

Twenty-five (25) percent thereof to be prorated and paid to the member in cash annually as soon as practical after the close of business at the end of each fiscal year and after the Auditor shall have completed the annual audit and shall have released his report to the Directors; seventy-five (75) percent thereof to be applied to the creation and maintenance of a "Feed Finance Fund" all as provided for elsewhere in these By-Laws.

Section 2 provides for the creation of a "Feed Finance Fund" of \$60,000 by retention of 75 percent of the members' purchase credits. It also provides for issuance to members of interest-bearing certificates, representing the amounts retained, and for retirement of such certificates in the order of issuance when that may be done without reducing the fund below \$60,000. (R. 126.)

An egg marketing pool for members is authorized by Section 3. The section further provides that the taxpayer may, in addition to the cost of marketing, with-

hold one cent from the proceeds of each dozen eggs marketed through the pool for the purpose of establishing an "Advance Fund." These deductions from proceeds of the taxpayer's marketing division are designated "Members' Egg Pool Credits", and the taxpayer, according to this section of the by-laws, is authorized to issue interest-bearing "Advance Fund Certificates" representing such deductions. Section 4 provides for creation of an advance fund, to be maintained at a level of \$60,000, and for retirement of the certificates in the order issued. (R. 126-128.)

The taxpayer is authorized by Section 9 (R. 130-131) to use any moneys in the feed finance fund and the advance fund for purchase of land, buildings, equipment, etc., or as working capital in the operation of the business.

Section 7 of Article VIII of the by-laws sets up a "Membership Fund" consisting of all membership fees paid to the taxpayer. This fund may also be invested in land, buildings, equipment, or used as working capital. (R. 129-130.) A reserve for security of the membership fund is established by Section 8, which provides as follows (R. 130):

SECTION 8. There shall be reserved out of the earnings of the business of the Association each year ten (10) per cent of the net earnings for a Reserve Fund for security of the Membership Fund; such amount shall be computed annually, deducted after all other deductions for interest, overhead and operating expenses have been made and before "Members' Purchase Credits" have been prorated.

Any moneys in this Reserve Fund or in any other Fund may be invested in property belonging to the Association, in outside securities, or used as a working capital in the operation of the business, * * *.

Section 10 of the same article authorizes the taxpayer to do business with nonmembers as well as members, and permits it to buy poultry and other agricultural produce from producers for cash if the board of directors deems it advisable. (R. 131.)

On December 21, 1936, the taxpayer's board of directors adopted the following several resolutions:

(1) A resolution authorizing the payment of patronage dividends to members and nonmembers alike, for the year 1936, in cash or its equivalent (R. 21);

(2) A resolution of the taxpayer's marketing division authorizing the creation of an account on the books of the taxpayer, designated "Reserve Against Loss by Overpayment", and reciting that the aggregate amount retained from proceeds of the sale of eggs marketed by the taxpayer for members during the year 1936 amounted to \$1,683.56, and that this amount was to be credited to a reserve for overpayments in order to avoid loss from market fluctuations, deterioration, carrying charges, or unexpected expenses in the marketing of eggs by the taxpayer (R.21);

(3) A resolution of the purchasing division authorizing that the sum of \$5,722.72 be transferred on the books of the taxpayer to an account entitled "Reserve for Zoning Hazard" (R. 21);

(4) A resolution of the purchasing division authorizing the transfer of \$2,215.29 to an account on the

books of the taxpayer entitled "Reserve for Security of Membership," this amount being 10 percent of the taxpayer's net earnings as shown by its books for the year 1936 (R. 22);

(5) Finally, a resolution of the purchasing division declaring a patronage dividend in the amount of \$14,214.93, consisting of \$11,725.75 to members and \$2,489.18 to nonmembers, to be paid in cash or its equivalent. The resolution stated that this amount represented a dividend to members of two percent on all purchases in addition to authorized reserves credited to members, and a larger dividend to nonmembers, "equalling in percentage the amount carried to reserves for accounts of members" (R. 22).

At a meeting held on December 31, 1937, the board of directors of the taxpayer adopted the following several resolutions:

(1) A resolution relating to both purchasing and marketing divisions, reciting that it was the intention of the taxpayer that its members should be credited on the books with their pro rata share of any amounts retained by the association which did not represent valuation reserves or other costs and expenses of the taxpayer, and that such credits should be paid to its members whenever its board of directors should determine that the taxpayer had available funds therefor, not needed for its use. The resolution authorized the accountants of the taxpayer to determine the amounts allocable as credits to the members, and to record such credits on the books of the taxpayer, and recited that

the taxpayer recognized the obligation to repay such credits in the manner stated (R. 22-23) ;

(2) A resolution of the purchasing division of the taxpayer's business authorizing transfer of \$9,657.81 on the books of the taxpayer to an account designated "Reserve for Zoning Hazard" (R. 23) ;

(3) A resolution of the purchasing division authorizing transfer of \$2,601.90 on the books of the taxpayer to the account "Reserve for Security of Membership," this amount being 10 percent of the net earnings of the taxpayer, as disclosed by its books for the year 1937 (R. 23) ;

(4) Finally, a resolution of the purchasing division declaring a patronage dividend in the amount of \$18,058.65, consisting of a dividend to members in the amount of \$17,924.32 and a dividend to nonmembers in the amount of \$134.33, to be paid in cash or its equivalent before closing its books for the year 1937. This dividend, like that in the previous year, was declared on a percentage basis to members and a larger percentage to nonmembers (R. 23).

The account designated "Reserve for Zoning Hazard" was set up to provide against the possibility of a change in the zoning ordinance of the City of Porterville. The plant of the taxpayer was in a residential region. Since there was a zoning ordinance authorizing the taxpayer to operate its plant, and the adjoining landowners asserted that its noise, dust, and dirt created a nuisance, against which they threatened legal action, the taxpayer felt that zoning restrictions might be enacted requiring removal of its plant to another site.

(R. 23.) The reserve for security of membership, authorized in the bylaws, is maintained for the purpose of protecting the taxpayer against any loss in its working capital. The reserve against loss by overpayment was established to protect the taxpayer against any payments of excessive amounts to members marketing their eggs in pools. The returns from the marketing of eggs were uncertain. When the taxpayer paid its members for eggs still unmarketed and at prices then quoted on the market, it ran the risk that it would not realize as much when the eggs were sold by it. Uncertainty in estimating expenses was also involved. This reserve was intended to protect the taxpayer against both these risks. When any of the amounts were transferred to the reserves described above, the taxpayer's books showed the credits to such reserves but there was no physical segregation of cash or funds representing the amounts of these reserves. All of the moneys of taxpayer were kept in one fund. (R. 26-27.)

The account of each member of the taxpayer was credited with a proportionate share of each of the three reserve funds and a statement of membership equity was sent annually to each member. (R. 27, 148-150, Pet. Ex. 13-14.) However, none of the amounts so credited could be withdrawn from these reserves by the members. (R. 27.) Authorization by the taxpayer's board of directors was necessary to make any portion of the reserves available to members. The policy of the board of directors was to authorize payment to members whenever the financial condition of the taxpayer was such that the amounts credited to the various

reserve accounts could be paid to members without any detriment to the taxpayer. It was understood at all times that all the moneys represented by the reserves, which were in turn credited to the various accounts of the members, could be used by the taxpayer for any of the purposes authorized in its by-laws. But if these amounts were to be used by the taxpayer for payment to members in cash or interest-bearing certificates, the payment had to be authorized by the board of directors of taxpayer. (R. 26-27.)

Patronage dividends, when declared, ^{were} ~~was~~ credited to the accounts of the members. (R. 27.) The amounts so declared by the resolutions of 1936 and 1937 were paid without any additional authorization by the board of directors. (R. 24.) Payments to the extent of 25 per cent of the amounts due were made in cash; the remainder in interest-bearing certificates, as provided in the by-laws. (R. 25-26, 27.)

In making its income tax returns for 1936 and 1937, the taxpayer claimed as deductions from its gross income the sums covered by all the above-enumerated resolutions. (R. 19-20.) The Commissioner allowed deductions of the amounts declared and distributed by the taxpayer as patronage dividends, and also \$4,299.35 of the \$9,657.81 allocated to the 1937 reserve for zoning hazard. (R. 4, 125.) He disallowed all the remaining amounts placed in the three reserve funds. (R. 12-17.)

Upon these findings the Board concluded that the amounts retained by the taxpayer and allocated to "Reserve for Zoning Hazard", "Reserve for Security of Membership", and "Reserve Against Loss by Over-

payment" remained in the control of the taxpayer, and that the mere crediting of the members' accounts with proportionate parts of the amounts so retained did not place those amounts at the disposal of the members. The Board, therefore, sustained the Commissioner's ruling disallowing deductions of the amounts held in reserve. (R. 28-32.)

SUMMARY OF ARGUMENT

The taxpayer, although a cooperative association, is not exempt from taxation under Section 101 (12) of the Revenue Act of 1936. Section 101 (12) exempts only those farmers' cooperative associations which return the proceeds of their marketing and purchasing operations to all patrons, whether members or nonmembers, on an equal basis. The taxpayer did not return marketing proceeds to nonmember patrons in 1936 and 1937, but instead purchased their produce for cash and resold it for its own account, in contrast to its method of doing business with members. The taxpayer concedes that it realized certain taxable net income from nonmembers. Even if the taxpayer had returned its proceeds equally to members and nonmember patrons, it is not exempt by Section 101 (12) because the reserve funds which it set up in 1936 and 1937 from proceeds are not shown to be reasonable reserves for necessary purposes as required by the statute.

The amounts of net proceeds retained by the taxpayer and placed in three reserve funds constitute income to the taxpayer. Neither the Agricultural Code of the

State of California nor the taxpayer's by-laws divest the taxpayer of ownership and control of its net proceeds. The right of members to receive any part of the proceeds is determinable solely by the taxpayer.

The amounts retained in reserve are not deductible from gross income as patronage dividends. There is no statutory provision allowing deduction of patronage dividends from the gross income of a cooperative association which is not exempt from taxation by Section 101 (12). By administrative practice, however, proceeds returned to patrons during the taxable year are deductible. The Board of Tax Appeals found that the amounts retained by the taxpayer in the reserves here in issue were not in fact returned to the members during those years. The record shows that the crediting of the account of each member with a *pro rata* share of each reserve did not constitute a return of the proceeds to the members. Payments were to be made to members from the reserves only "when, as, and if" the directors determined the taxpayer did not need the funds retained. Only by further action of the taxpayer's board of directors can the amounts so credited become available to the members. Until such further action the credits are not a fixed liability of the taxpayer to its members, for they can maintain no suit for recovery of the credits. Since the amounts of net proceeds retained in the reserves remained solely in the control of the taxpayer during 1936 and 1937, the taxpayer was not entitled to deduct those amounts from its gross income of those years.

ARGUMENT

The taxpayer is not entitled to deduct from the gross income of the taxable years amounts retained and credited to the reserve funds, even though allocable portions of the amounts so retained were credited to the accounts of its members on a patronage basis

- a. The taxpayer is not tax-exempt under Section 101 (12) of the Revenue Act of 1936, since it realizes profit from its business with nonmembers

The taxpayer, although a cooperative association, is not entitled to exemption from taxation under the provisions of Section 101 (12) of the Revenue Act of 1936 (Appendix, *infra*). Section 101 (12) exempts only (1) those farmers' cooperative marketing associations which turn back to the producers the proceeds of the sales, less the necessary marketing expenses, on the basis of the products furnished by them, and (2) those farmers' cooperative purchasing associations which turn over supplies to purchasers at actual cost plus necessary operating expenses. By way of interpretation of this section, Article 101 (12)-1 of Treasury Regulations 94 (Appendix, *infra*) provides:

* * * nonmember patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association.

* * * * *

An association engaged both in marketing farm products and in purchasing supplies and equip-

ment is exempt if as to each of its functions it meets the requirements of the Act.

Thus, a cooperative association which fails to accord equal treatment to all its patrons, whether members or nonmembers, with regard to the distribution of proceeds realized from both marketing and purchasing operations is not entitled to the statutory exemption. *Farmers Union Co-op. Co. v. Commissioner*, 90 F. 2d 488 (C. C. A. 8th); *Fruit Growers' Supply Co. v. Commissioner*, 56 F. 2d 90 (C. C. A. 9th); *South Carolina Produce Ass'n v. Commissioner*, 50 F. 2d 742 (C. C. A. 4th); *Producers' Creamery Co. v. United States*, 55 F. 2d 104 (C. C. A. 5th); *Fertile Co-operative Dairy Ass'n v. Huston*, 119 F. 2d 274 (C. C. A. 8th); *Farmers Co-operative Co. v. United States*, 23 F. Supp. 123 (C. Cls.); *Farmers Union Co-operative S. Co. v. United States*, 23 F. Supp. 128 (C. Cls.), motion for new trial denied, 25 F. Supp. 93.

The taxpayer did not satisfy the statutory requirements in 1936 and 1937, the taxable years involved. Through its marketing division during those years, the taxpayer marketed eggs for its members in weekly pools and returned to them the proceeds less estimated expenses. It also sold eggs obtained from nonmembers. The nonmembers, however, did not participate in the marketing pools. Instead, the taxpayer made outright purchases of their eggs for cash and resold them for its own account. (R. 52-53.) In the purchasing division feed and supplies were sold to members on the basis of cost plus estimated expense of handling. (R. 54.) Sales were also made to nonmem-

bers. (R. 53-54.) The taxpayer itself, in its petition to the Board for redetermination of deficiency (R. 3-9), concedes that it realized certain net income from its dealings with nonmembers in 1936 and 1937 which was taxable net income (R. 7-9). Although patronage dividends from its proceeds were distributed to both members and nonmembers in 1936 and 1937, the resolutions of the board of directors disclose that such dividends were declared only with respect to the taxpayer's sales of feed and supplies, which were handled through its purchasing division. (R. 137-138, 143-145, Pet. Ex. 5, 10.) Nonmembers did not receive any *pro rata* return of proceeds from operations of the marketing division of the taxpayer. (R. 8, 52-53, 136, Pet. Ex. 4.) For this reason alone the taxpayer is not entitled to the statutory exemption. *Farmers Union Co-op. Co. v. Commissioner, supra*; *Fruit Growers' Supply Co. v. Commissioner, supra*; *South Carolina Produce Ass'n v. Commissioner, supra*. The fact that the percentage of business with nonmembers was relatively small is without significance. *Fruit Growers' Supply Co. v. Commissioner, supra*, p. 92. Nor does the fact that the taxpayer may have been operating in accord with the California statutes under which it was incorporated give it an exempt status under Section 101 (12), for the exemption depends solely on the terms of the federal statute and compliance or noncompliance with state statutes is irrelevant. *Farmers Union Co-op. Co. v. Commissioner, supra*, p. 492; *Farmers Co-operative Co. v. United States, supra*.

b. There is no evidence that the reserve funds for which deductions have been disallowed are reasonable reserves for necessary purposes within the meaning of Section 101 (12)

Even if the taxpayer here had treated its member and nonmember patrons equally with regard to the distribution of the proceeds of both its marketing and purchasing operations, it would not qualify as a corporation exempt from taxation under Section 101 (12). To gain exemption under Section 101 (12), it is incumbent upon the association to establish that any reserve which it has set up is a reasonable reserve for a necessary purpose,¹ "such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes". Treasury Regulations 94, Article 101 (12)-1. See *Fertile Co-operative Dairy Ass'n v. Huston*, *supra*, p. 276. Cf. *Burr Creamery Corp. v. Commissioner*, 62 F. 2d 407 (C. C. A. 9th), certiorari denied, 289 U. S. 730; *Riverdale Co-op. Creamery Ass'n v. Commissioner*, 48 F. 2d 711 (C. C. A. 9th); *Uniform Printing & S. Co. v. Commissioner*, 33 F. 2d 445 (C. C. A. 7th), certiorari denied, 280 U. S. 591.

The taxpayer failed to establish that the three reserve funds for which the Commissioner disallowed

¹ Section 101 (12) also provides that exemption shall not be denied an otherwise qualified cooperative association because it maintains reserves "required by State law." The taxpayer here makes no contention that the reserves in issue are required by the California statutes under which it is incorporated. Our examination of these statutes discloses no requirement that reserves be maintained. See Deering, *Agricultural Code of the State of California* (1937), Sections 1191-1221.

deductions were reasonable reserves for necessary purposes, and the Board of Tax Appeals so found. (R. 28-29.) The reserves here in issue are designated by the taxpayer as (1) "Reserve for Zoning Hazard", (2) "Reserve Against Loss by Overpayment for Eggs", and (3) "Reserve for Security of Membership Fund". They were set up from proceeds, otherwise distributable to members, to protect the taxpayer against possible future contingencies (R. 45, 62-63, 65, 68-69), and were in addition to the customary annual reserves for depreciation and bad debts (R. 137, Pet. Ex. 5; R. 139, Pet. Ex. 7; R. 142, Pet. Ex. 9; R. 143, Pet. Ex. 10). As the Board of Tax Appeals points out, the taxpayer introduced no substantial evidence as to the reasonableness of the amount set aside in the zoning hazard reserve. The testimony discloses only that removal of the taxpayer's plant from the residential area where it was located or remodeling of the plant "would probably cost considerable money." (R. 62.) It is important to note that the Commissioner allowed the taxpayer to deduct from its gross income in 1937 the sum of \$4,299.35 on account of the zoning hazard. The taxpayer had set aside in 1937 a total of \$9,657.81. (R. 145, Pet. Ex. 11.) The Commissioner disallowed only \$5,358.46 of that amount. (R. 15.) In the absence of evidence that the Commissioner's ruling was erroneous, this administrative determination of the reasonable limit for such a reserve must be sustained by this Court. *Matern v. Commissioner*, 61 F. 2d 663 (C. C. A. 9th); *Lightsey v. Commissioner*, 63 F. 2d 254 (C. C. A. 4th).

The reserve against loss by overpayment for eggs was explained as a fund for protection of the taxpayer

against losses "at sometime in the future," because of miscalculation of marketing expenses or in the event of market fluctuations between the time the eggs were received from producers and the time they were marketed. (R. 69.) The extent of such losses in other years, if any, is not disclosed. The reserve for the security of membership fund, according to the testimony of the general manager, was "for the purpose of protection against loss and the supplying of capital working fund." (R. 68.) The record does not show the extent of the taxpayer's need of additional working capital. The by-laws of the taxpayer provide other sources of substantial working capital for the taxpayer's operations. (R. 124-128, 129-131, Pet. Ex. 1, By-laws, Art. 8, Secs. 1-4, 7, 9.) In 1936 and 1937, 75 percent of the current patronage dividends declared were paid in interest-bearing certificates, and the moneys represented by such certificates were thus made available to the taxpayer. (R. 137-138, Pet. Ex. 5; R. 143-145, Pet. Ex. 10.) In brief, the taxpayer offered no satisfactory proof either of the reasonableness of the amounts retained and allocated to these reserves or of the necessity for such reserves.² The burden is on the taxpayer to establish by substantial evidence that any reserve which it set up was reasonable and necessary in the situation. *Welch v. Helvering*, 290 U. S. 111; *Fertile Co-operative Dairy Ass'n v. Huston*, *supra*; *Matern v. Commissioner*, *supra*. Clearly, the taxpayer here, as the Board found (R. 28-29), did not sustain that burden.

² There is likewise no evidence that the taxpayer is entitled to deduct from gross income the amounts retained as reserves for ordinary and necessary business expenses.

c. The amounts of net profits retained in reserve constitute income to the taxpayer and not to its members

Since the taxpayer is not exempt from taxation by Section 101 (12), the Commissioner correctly included in the taxpayer's gross income the amounts of net proceeds retained by it and placed in reserve funds. The net proceeds from the operations of a nonexempt cooperative marketing and purchasing association constitute income to the association. *Farmers Union Co-op. Co. v. Commissioner, supra*; *Co-operative Oil Ass'n v. Commissioner*, 115 F. 2d 666 (C. C. A. 9th); *Fruit Growers' Supply Co. v. Commissioner, supra*; *Farmers Union Cooperative S. Co. v. United States*, 25 F. Supp. 93 (C. Cls.). An incorporated cooperative association, like any other corporation, is a distinct corporate entity, existing separate and apart from its members. As such, the proceeds of its business belong to it and not to its members. *Farmers Union Co-op. Co. v. Commissioner, supra*; *Callaway v. Farmers Union Cooperative Ass'n*, 119 Nebr. 1, 226 N. W. 802.

The Agricultural Code of the State of California (See Deering, Agricultural Code of the State of California (1937), Sections 1191-1221) does not divest the taxpayer here of the proceeds of its operations and thereby relieve it of an obligation to pay federal income taxes on its net earnings. The statute does not vest the proceeds either in patrons or members, but leaves such proceeds in the sole control of the taxpayer without even specific provision for their distribution. The taxpayer is empowered, under the statute, to exercise all ordinary corporate powers, including the right to own property and to establish reserves and invest funds.

Likewise, the taxpayer's by-laws do not divest the taxpayer of sole control of the proceeds of its business. Under the by-laws, they may be expended for the purchase of land, buildings, equipment and supplies, or used as working capital. (R. 124-131, Pet. Ex. 1.) It is true that the by-laws state that the "Net Proceeds" shall belong to the members, but this provision apparently refers only to the proceeds of the "Purchasing Division" of the taxpayer's business. (R. 124-125, Pet. Ex. 1.) Moreover, the rights of members to possess the proceeds is vested solely in the discretion of the directors. Paragraphs 18th and 19th of Section 11, Article IV (R. 115-116, Pet. Ex. 1), empower the board of directors to create and maintain reserve funds for any purpose and "after making such financial provisions * * * as they deem for the best interest of the Association, * * * *to refund to the members * * * the balance* of any overcharges from sales * * *." (Italics supplied.) Section 1 of Article VIII (R. 125, Pet. Ex. 1) authorizes the board of directors, "after providing for all necessary overhead and all duly authorized reserves," to prorate and *refund to the members the remainder of the net proceeds* resulting from the operations of the business. We submit that under the statute and by-laws there can be no other conclusion than that the proceeds of the business constitute income to the taxpayer. The taxpayer's contention to the contrary is fully disposed of by the Eighth Circuit Court of Appeals in *Farmers Union Co-op. Co. v. Commissioner, supra*, where that court considered a similar contention and concluded that the

proceeds of a cooperative association which transacted business with both members and nonmembers constituted taxable income to the association.

- d. The amounts retained in reserve are not deductible from the taxpayer's gross income as patronage dividends, even though allocable portions of the amounts so retained were credited to the accounts of its members on a patronage basis, since such credits were not immediately available to the members

The taxpayer contends that, even if the reserves are not otherwise exempt from taxation, substantially all its net proceeds in 1936 and 1937, including the amounts retained in the reserve funds, were deductible from its gross income as so-called patronage dividends. This Court recognized in *Co-operative Oil Ass'n v. Commissioner*, *supra*, that there is no express statutory provision permitting the deduction of patronage dividends by cooperative associations which do not qualify as tax-exempt cooperatives under the appropriate revenue laws. The administrative practice, however, has been to permit cooperative associations, even though not entitled to a tax-exempt status, to deduct from gross income the amounts returned to their patrons, whether members or nonmembers, upon the basis of purchases or sales, or both, made by or for them. See I. T. 1499, I-2 Cum. Bull. 189 (1922); A. R. R. 6967, III-1 Cum. Bull. 287 (1924); *Trego County Cooperative Association v. Commissioner*, 6 B. T. A. 1275; *Home Builders Shipping Association v. Commissioner*, 8 B. T. A. 903; *Anamosa Farmers Creamery Co. v. Commissioner*, 13 B. T. A. 907; *Farmers' Union Co-operative Association v. Commissioner*, 13 B. T. A. 969; *Fruit Growers Supply Co. v. Commissioner*, 21 B. T. A. 315;

Midland Cooperative Wholesale v. Commissioner, 44 B. T. A. 824. Such deductions are solely a matter of administrative grace and are not permitted unless the amounts have in fact been returned to members or patrons of the association during the taxable year. *Co-operative Oil Ass'n v. Commissioner*, *supra*; *Farmers Union Co-op Co. v. Commissioner*, *supra*; *Farmers Union Co-operative S. Co. v. United States*, 25 F. Supp. 93 (C. Cls.); *Fruit Growers' Supply Co. v. Commissioner*, *supra*. Actual payment during the taxable year is not required, but the association must have taken whatever action is necessary to give its members an immediate right to possess the funds. See *Home Builders Shipping Association v. Commissioner*, *supra*; *Midland Cooperative Wholesale v. Commissioner*, *supra*. A return of proceeds to the patrons of a cooperative association ordinarily can be accomplished only by the actual declaration and distribution of a patronage dividend by its board of directors. Until such action, the proceeds belong to the association, which is a separate corporate entity, and the patrons have no greater interest in them than stockholders have in the undistributed earnings of an ordinary corporation. *Farmers Union Co-op Co. v. Commissioner*, *supra*; *Callaway v. Farmers Union Cooperative Ass'n*, *supra*. See also *Fruit Growers' Supply Co. v. Commissioner*, *supra*; *Co-operative Oil Ass'n v. Commissioner*, *supra*; *Burr Creamery Corp. v. Commissioner*, *supra*. Cf. *Penn Mutual Co. v. Lederer*, 252 U. S. 523.

The amounts here in issue, although constituting net proceeds of the taxpayer's business, were not declared and paid by the taxpayer as a part of the patronage

dividends returned to members in 1936 and 1937. (R. 137-138, Pet. Ex. 5; R. 143-145, Pet. Ex. 10.) In contrast to the patronage dividends of those years, which became available to members in cash or interest-bearing certificates as soon as declared by resolutions of the taxpayer's board of directors, these amounts were retained in reserves. The taxpayer argues, however, that the crediting of *pro rata* shares of the reserves to the account of each of its members constituted a distribution of the reserves and created a liability of the taxpayer to its members. As such, the taxpayer contends the Commissioner should have allowed the amounts so allocated during the taxable years to be deducted from gross income. The Board of Tax Appeals rejected this contention and concluded that further action by the taxpayer's board of directors was necessary before any portion of these reserves could become available to the members. (R. 31.) The evidence amply supports the Board's conclusion.

The resolution of the board of directors allocating to members the *pro rata* shares of the reserve funds states (R. 141):

Such credits shall be paid * * * *when, as, and if the board of directors of the association determines that the association has available funds therefor* not to be needed for the use of the association; * * * [Italics supplied.]

Nor did the resolutions of the board of directors creating the three reserve funds authorize payments to members from these funds. (R. 136, Pet. Ex. 4; R. 138-139, Pet. Ex. 6-7; R. 142-143, Pet. Ex. 9; R. 145,

Pet. Ex. 11.) Testimony of the general manager establishes that only by further action of the board of directors could the amounts so credited become available to the members. (R. 66, 68, 70-71, 73.) If the contingencies should arise for which the reserves were established, the by-laws permitted, and it was the intention of the taxpayer to expend the amounts therein for the specified purposes. (R. 73.) Thus, the amounts in reserve could not be depleted by the members at any time, and were to become available to the members only when and if the board of directors so ordered. Moreover, the resolution above quoted establishes that the taxpayer was under no fixed liability to the members. Any payment from the reserves was conditioned on determination by the taxpayer's board of directors that the taxpayer did not need the funds for its own use. The existence and extent of the liability was, therefore, not fixed by action of the taxpayer in the taxable years involved, but was contingent upon future events. See *Commissioner v. Brooklyn R. S. Corp.*, 79 F. 2d 833 (C. C. A. 2d). This Court in *Co-operative Oil Ass'n v. Commissioner*, *supra*, held that a resolution providing for retention of net proceeds in a reserve for working capital and for payment to members from the reserve at some time in the future when a sufficient reserve had been accumulated did not constitute a distribution of patronage dividends within the taxable year. The additional fact in the present case that *pro rata* shares were credited to the accounts of each member does not constitute the distribution lacking in the *Co-operative Oil Ass'n* case. This is true because the credits were conditional and

until the board of directors of the taxpayer takes action releasing the credits to members there is no fixed right in the members on which they can maintain suit for recovery. *Callaway v. Farmers Union Cooperative Ass'n*, *supra*. Cases relied upon by the taxpayer (*Bogardus v. Santa Ana W. G. Assn.*, 41 Cal. App. 2d 939, 108 P. 2d 52; *Loomis F. G. Assn. v. California F. Exch.*, 128 Cal. App. 265, 16 P. 2d 1040) are not to the contrary. They indicate only that, after a cooperative association has declared a patronage dividend *and the date fixed for payment has passed*, a member may bring suit to recover the amount due.

Midland Cooperative Wholesale v. Commissioner, *supra*, relied upon by the taxpayer (Br. 29-32), is distinguishable. In that case the Board found that no additional corporate action was required to make immediately available to the members the amounts credited to them. In contrast, the Board has found here that further corporate action is necessary. Moreover, in that case deduction of amounts placed in a permanent surplus, similar to the reserve funds here, was disallowed.

We therefore submit that the amounts retained in reserve by the taxpayer did not constitute proceeds returned to the members within the taxable year and were, therefore, not deductible from gross income by virtue of the administrative practice permitting deduction of patronage dividends. What this Court said in *Co-operative Oil Ass'n v. Commissioner*, *supra*, p. 668, is fully applicable to the taxpayer's contention here:

* * * petitioner points to no statute authorizing any deduction whatever, and we are in effect asked to hold that a practice of respondent permitting a deduction not authorized by statute, is not liberal enough. We know of no manner in which such liberality may be reviewed in this court. It is familiar law that "Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed" and "a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms". *New Colonial Ice Co. v. Helvering*, 292 U. S. 435, 440, 54 S. Ct. 788, 790, 78 L. Ed. 1348. See also: *White v. United States*, 305 U. S. 281, 292, 59 S. Ct. 179, 83 L. Ed. 172.

CONCLUSION

The decision of the Board is correct and it should be affirmed.

Respectfully submitted,

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DECEMBER, 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this title—

* * * * *

(12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a re-

serve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph;

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 101 (12)-1. *Farmers' cooperative marketing and purchasing associations.*—(a) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, live stock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of the products furnished by them, are exempt from income tax and shall not be required to file returns. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Act and is not exempt. In other words, non-member patrons must be treated the same as members in so far as the distribution of patron-

age dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Act that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Act does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Act patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

An association which has capital stock will not for such reason be denied exemption, (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (2) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership

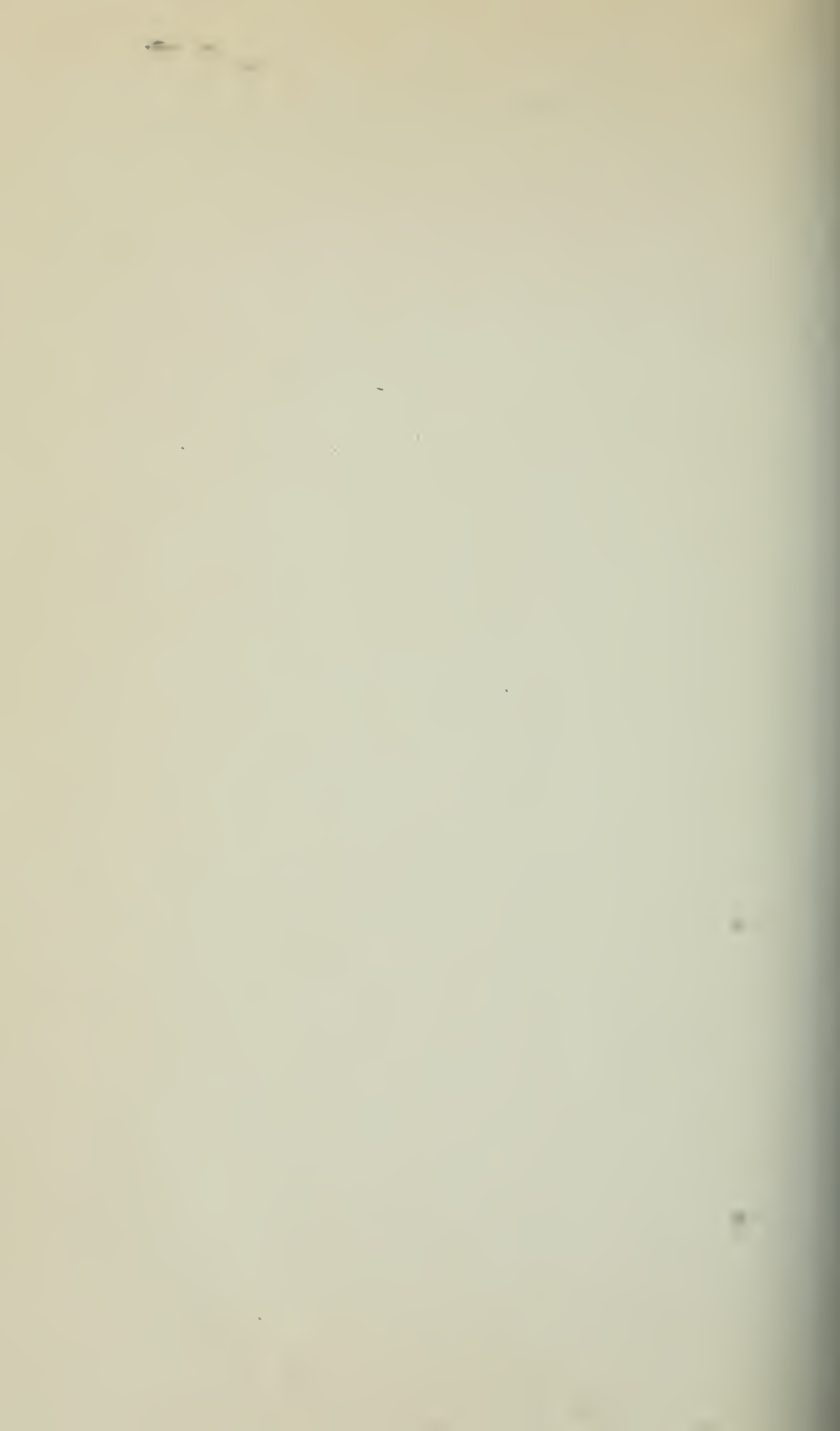
of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to partici-

pate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, live-stock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101 (12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (a) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either (a) or (b) an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in paragraph (a). An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Act. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101 (12) and this article. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 101 (12).





IN THE
United States Circuit Court of Appeals
FOR THE NINTH CIRCUIT.

No. 10246.

SAN JOAQUIN VALLEY POULTRY PRODUCERS
ASSOCIATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF AMICUS CURIAE OF NATIONAL COUNCIL
OF FARMER COOPERATIVES.

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Attorney for National Council of Farmer Coopera-
tives.

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**BRIEF AMICUS CURIAE OF NATIONAL COUNCIL
OF FARMER COOPERATIVES.**

I.

**APPLICATION FOR LEAVE TO FILE BRIEF
AMICUS CURIAE.**

Now appears The National Council of Farmer Cooperatives, having its principal office at 1731 Eye Street, N. W., Washington, D. C., acting through Eugene L. Hensel of Columbus, Ohio, its attorney, and respectfully requests leave of court to file a brief amicus curiae in this action.

Your applicant represents that it is an association with a direct membership of two hundred and thirty-five federated agricultural cooperatives, which, in turn, have members consisting, in the aggregate, of approximately forty-five hundred individual agricultural cooperative associations, serving approximately two million farmers located in all portions of the United States. The questions of fact and law involved in this pending action are of vital importance to the applicant and its constituent members, inasmuch as the marketing of farm products and purchase and distribution of farm supplies are, to a very large extent, conducted through the medium of farmer-owned agricultural associations. Hence, the issues before this court in this cause are of great public importance, and the decision of the court will have a widespread effect, not alone upon the business and affairs of the petitioner, but upon the hundreds of other agricultural cooperatives which are organized and transact their business in a manner similar to the petitioner.

Respectfully,

EUGENE L. HENSEL,

8 East Long Street, Columbus, Ohio,
Attorney for National Council of Farmer Cooperatives.

II.

STATEMENT OF FACTS.

(1) The petitioner is a bona fide agricultural cooperative association organized under the Agricultural Non Profit Cooperative Marketing Association Act of the state of California. It is organized on a membership basis, with a \$10.00 membership fee. By the terms of Article II of its Articles of Incorporation, the petitioner is prohibited from paying any dividend or interest on membership certificates (R., p. 95). Membership is limited to bona fide producers of agricultural products. The petitioner is engaged in marketing poultry and eggs on behalf of its members and others, and in selling and furnishing farm supplies to its members and others. The volume of nonmember business of the petitioner was very small. With respect to its marketing transactions, in 1936 nonmember business represented 1.77% of the total business, and in 1937 it represented .11% of the total business (R., p. 78). Marketing of nonmember eggs was treated as cash purchases (R., p. 52). In purchasing supplies the volume of nonmember business in 1936 was 10.47% of the total business, and in 1937 it was .52% of the total business (R., p. 78).

(2) In marketing farm products and purchasing farm supplies, it was the practice of the petitioner to operate at cost, plus an estimated margin for expenses incurred in transacting business. At the end of each year the income and expense was calculated, and if it was found that there was an excess of income over expense, that excess ~~of~~ overcharge was distributed to patrons in propor-

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tion to their patronage (R., p. 54). In the payment of patronage refunds, the petitioner observed an equality of treatment between member and nonmember patrons (R., p. 54 and R., p. 135). All of the patronage refunds due nonmember patrons were paid to them in cash, and were at a higher percent than those paid member patrons because only a portion of the refunds due member patrons was paid in cash, the remainder being credited to the member patrons in certain reserve accounts carried on the records of the petitioner. The difference between the actual cash refunds paid to nonmembers and members was represented by the interest of the member patrons in the reserve accounts and credited to each specific member.

(3) During the years 1936 and 1937, the following resolutions were adopted by the board of directors of the petitioner, to wit:

(a) Resolution adopted December 21, 1936, authorizing payment of patronage refunds for the year 1936 to members and nonmembers alike, and directing the employees of the petitioner to execute the terms of the resolution (R., p. 135).

(b) Resolution adopted December 31, 1936, authorizing the creation of a reserve account designated as "Reserve Against Loss by Overpayment" in the amount of \$1,683.56, representing accumulation of retentions from proceeds of sale of members' eggs in the year 1936, and created to avoid the possibility of loss due to market fluctuations, deterioration, carrying charges and unexpected expenses (R., p. 136).

(c) Resolution adopted December 31, 1936, declaring patronage refunds for the year 1936 to members at the

rate of 2% on member purchases, and to nonmembers at the rate of 3½% on nonmember purchases, and reciting that the difference in the rate payable to members and nonmembers represented the amount carried to the reserves for the account of members. The resolution further authorized the payment in cash to members and nonmembers of the refunds so declared, the total amount being \$14,214.93, of which \$11,725.75 was payable to members and \$2,489.18 was payable to nonmembers (R., p. 137).

(d) Resolution adopted December 31, 1936, authorizing the creation of a reserve designated as "Reserve for Zoning Hazard", in the amount of \$5,722.72 (R., p. 138). This reserve was created against a contingency which might arise due to complaints from abutting property owners that the operation of petitioner's business constituted a nuisance and might result in the necessity of outlay in moving or altering its facilities (R., p. 23).

(e) Resolution adopted December 31, 1936, authorizing the transfer of the sum of \$2,215.29, being 10% of the petitioner's net savings or overcharges for the year 1936, from the operating account to the "Reserve for Security of Membership", and directing that the interest of each member in this fund be pro rated and credited upon the records (R., p. 139).

(f) Resolution adopted December 31, 1937, affirming the proposition that the petitioner was organized and operating as a nonprofit cooperative association on a cost basis, plus expenses. It further recited that the individual members and patrons should be credited on the books of the petitioner with their pro rata share of any amounts retained by the petitioner which did not represent valuation reserves or current costs and ex-

penses for transacting business. It further directed the accounting officers to record credits due to members upon the books of the petitioner for the amounts allocable to each member. It further recited that the credits so allocated to each member patron should be paid as and when the board of directors should determine petitioner had available funds therefor (R., p. 140).

(g) Resolution adopted December 31, 1937, authorizing the transfer of the sum of \$2,601.90, being 10% of the petitioner's net savings or overcharges for the year 1937, from the operating account to the "Reserve for Security of Membership", and directing that the interest of each member in this fund be pro rated and credited upon the records (R., p. 142).

(h) Resolution adopted December 31, 1937, declaring patronage refunds for the year 1937 to members at the rate of 2% on member purchases, and to nonmembers at the rate of 2.87% on nonmember purchases, and reciting that the difference in the rate payable to members and nonmembers represented the amount carried to the reserves for the account of members. The resolution further authorized the payment in cash to members and nonmembers of the refunds so declared, the total amount of refunds being \$18,058.65, of which \$17,924.32 was payable to members and \$134.33 was payable to nonmembers (R., p. 143).

(i) Resolution adopted December 31, 1937, authorizing the transfer of the sum of \$9,657.81 from the operating account to the "Reserve for Zoning Hazard" (R., p. 145).

(4) The books, records, ledgers, and accounts of the petitioner were so kept that the allocated interest of each member in the three reserves, to wit: "Reserve for Se-

curity of Membership", "Reserve for Zoning Hazard", and "Reserve Against Loss by Overpayment", was set forth in minute detail (R., pp. 148, 149). From time to time certificates were issued to the members indicating to them their respective interests in the aforesaid reserves. Whenever a reserve, which was used for working capital, reached adequate proportions, the board of directors authorized the disbursement of the retained amounts to the respective members. In the redemption of these certificates, the older certificates were first redeemed. This is known as the revolving fund plan, whereby upon the accumulation of new retentions an equal amount of older retentions are redeemed or retired, thus stabilizing at all times the amount in the reserve required for working capital (R., p. 75).

(5) The petitioner filed with the collector of internal revenue income tax returns for the years 1936 and 1937. The returns for neither year disclosed any net income subject to taxation. Upon audit and review of the returns, the commissioner of internal revenue disallowed as deductions from gross income for said years the amounts credited by the petitioner to the "Reserve for Security of Membership", the "Reserve for Zoning Hazard", and the "Reserve Against Loss by Overpayment", and assessed a tax deficiency for said years in the amount of \$4,308.49. Thereupon, the petitioner perfected an appeal to the Board of Tax Appeals, which affirmed the findings of the commissioner of internal revenue and entered judgment thereon. The petitioner now prosecutes a petition for review of the order and decision of the Board of Tax Appeals by this court.

III.

STATEMENT OF ISSUE.

Broadly speaking, the sole issue before this court is whether the commissioner of internal revenue erred in disallowing as deductions from gross income of the petitioner for the years 1936 and 1937 the amounts credited by the petitioner to the respective accounts of its individual members in the "Reserve Against Loss by Overpayment", the "Reserve for Security of Membership", and the "Reserve for Zoning Hazard", and whether the Board of Tax Appeals erred in affirming the findings of the commissioner of internal revenue.

From a close examination of the decision of the Board of Tax Appeals, it would appear that the issue was even more narrowly limited to the question as to whether further or additional corporate action was necessary to be taken, other than that shown by the record, in order to fix or create liability on the part of the petitioner to its members for their respective aliquot portions of the three reserve accounts.

To rephrase the issue, it appears that if, at the end of each fiscal year, there existed a fixed liability on the part of the petitioner to its members, for payment to them of their respective credited amounts in the reserves, then, and in that event, the amounts represented by said reserves were allowable deductions from gross income. But, if, on the other hand, there was no fixed corporate liability for payment by the petitioner to its members of the amounts represented by said reserves, such amounts would constitute income of the corporate entity, as such, as distinguished from its members, and would be disallowed as deductions from gross income for the years in question.

IV.

**ARGUMENT IN SUPPORT OF CONTENTION THAT
AMOUNTS CREDITED BY PETITIONER TO
"RESERVE FOR SECURITY OF MEMBERSHIP",
"RESERVE FOR ZONING HAZARD", AND "RE-
SERVE AGAINST LOSS BY OVERPAYMENT",
ARE DEDUCTIBLE FROM GROSS INCOME.**

In this brief *amicus curiae*, we desire to concur in the position taken by the petitioner that the amounts credited during the years 1936 and 1937 to the "Reserve for Security of Membership", the "Reserve for Zoning Hazard", and the "Reserve Against Loss by Overpayment", are deductible from gross income for purposes of computing and determining federal income tax. Our position is based upon two propositions:

(1) The amounts represented by these reserves never were income of the corporate entity, but at all times constituted property of the individual members, temporarily in the custody or possession of the petitioner, by reason of the method by which the petitioner and its members transacted business, and subject ultimately to be returned to the custody and possession of the individual members; and,

(2) If the amounts represented by these reserves are to be considered as included in gross income of the petitioner, on the theory that any moneys which it physically receives constitute gross income, then such amounts are deductible from gross income in arriving at the net income of the corporate entity because of the fact that

there is a fixed liability on the part of the petitioner to ultimately repay said funds to its members.

But, in either event, it is strongly urged that there is a fixed and definite liability on the part of the petitioner to its members for the amounts retained and credited to the reserves in question.

A. The Provisions of the Articles of Incorporation and the By-laws of the Petitioner Create a Liability on the Part of the Petitioner to Its Members For Payment of Amounts Credited to Reserve Accounts.

The rule that the articles of incorporation and the by-laws of an association constitute a contract with its members is too thoroughly established to require citation of authority.

In Article VI of the Articles of Incorporation of the petitioner (R., pp. 97, 98) it is provided that upon dissolution the assets of the petitioner shall be distributed in the following order of priority: (1) To the payment of general indebtedness as distinguished from amounts owing members; (2) Next, up to the face value of the Feed Finance Fund Certificates, if any, with interest; (3) Next, not to exceed the face value of the membership certificates; (4) And finally, the residue, if any, to the holders of the Feed Finance Fund Certificates and Advance Fund Certificates in proportion to the patronage of the holders of such certificates with the petitioner, limited to the period within which the certificates may have accumulated.

In paragraph 22 of Section 11 of the by-laws (R., p. 116), the board of directors is granted power, under certain circumstances, to levy assessments on members

and, upon the occurrence of certain acts of default, to sell membership certificates and to forfeit all right, title and interest of a delinquent member in the property and assets of the petitioner. But any such action **“shall not relieve the association under its obligation under any outstanding Advance Fund Certificates held by said delinquent member”**.

In Article VIII of the by-laws (R., p. 124 et seq.), “net proceeds” are specifically defined to be such funds as are derived from overcharges on sales and as are left after all expenses have been paid or provided for. It is provided, further, that the “net proceeds” shall belong to the members and shall be pro rated to them in proportion to the amount of business each member has transacted with the petitioner.

The article further defines the various sub-funds and their inter-relation to each other. In this article provision is also made for partial payments of patronage refunds in cash and partial payments by crediting the remainder of the funds to reserve accounts. It also provides for retirement of certificates issued against reserve accounts in the order of their issuance on the revolving fund plan. In Section 8 of this article (R., p. 130), specific provision is made for the “Reserve for Security of Membership”.

In Article IX of the by-laws (R., p. 132), the provision for disposition of assets upon liquidation or dissolution follows the outline set forth in Article VI of the Articles of Incorporation, *supra*.

As each new applicant is accepted for membership by the petitioner, there is transmitted to him, in addition to a copy of the by-laws, an explanatory letter (R., p. 146), definitely stating the manner in which the peti-

tioner operates; that retentions will be made from amounts due the member; and that part of the retentions will be refunded in cash and part credited to his account in reserves. He is further notified that the plan of operation provides for either immediate partial distribution in cash or a future distribution in cash, or its equivalent.

Under these circumstances a member, in dealing with the petitioner, has fully acquiesced in the procedure followed by the petitioner in transacting its business, including the partial retention of refunds due the members, with the understanding that while the same constitute the property of the members, they may not actually be disbursed to the members until some future date.

Thus, it will be seen that the contract between the petitioner and its members, consisting of the application for membership, the acceptance thereof, the articles of incorporation, and the by-laws, and affirmed by the transactions between the petitioner and its members, specifically provides that refunds accruing to the account of the member, but retained by the petitioner, are at all times the property of the member, subject only to being reduced to possession by him at such time as the board of directors may determine funds are available therefor.

Summarizing these facts, the liability of the petitioner to the members is definitely fixed and determined by contract, and any attempt by the petitioner to evade the liability so created would constitute a flagrant breach of the contract existing between the petitioner and its members.

The creation of liability on the part of a cooperative agricultural association to its members, by virtue of contract, is a matter neither new nor novel in the applica-

tion of the federal income tax laws. Recognition of this principle is found in adjudicated cases.

In **Farmers Union Cooperative Association v. Commissioner of Internal Revenue**, 13 B. T. A., 969, recognition was given to contractual liability of the association, created by the provisions of its by-laws.

In **Home Builders Shipping Association v. Commissioner of Internal Revenue**, 8 B. T. A., 903, the contractual liability arose out of oral agreements between representatives of the association and the stockholder members, whereby the stockholder members were induced to purchase stock in consideration of the future liability of the association to pay patronage refunds.

In **Anamosa Farmers Creamery Co. v. Commissioner of Internal Revenue**, 13 B. T. A., 907, the contractual liability of the association was fixed by virtue of the provisions of the by-laws.

In **Midland Cooperative Wholesale v. Commissioner of Internal Revenue**, 44 B. T. A., 824, contractual liability arising out of the provisions of the articles of incorporation and the by-laws of the association was recognized and affirmed by the Board of Tax Appeals.

B. Resolutions of the Board of Directors Constitute a Recognition, Affirmance, and Ratification of Liability on Part of Petitioner to Its Members For Payment of Amounts Credited to Reserve Accounts.

Based upon the facts hereinabove recited, and the authorities noted, we advance the proposition that the provisions of the articles of incorporation and the by-laws of the petitioner, creating liability on the part of the petitioner to its members for the amounts credited to

the members in the aforesaid reserves, were self-executing. In other words, the contractual liability of the petitioner was so definitely fixed that we doubt any further action on the part of the petitioner was necessary with respect thereto.

However, the board of directors of the petitioner, apparently actuated by the theory that the provisions of the articles of incorporation and the by-laws constituted a mandate to the board of directors to take action necessary to execute such provisions, passed a series of resolutions as shown by the record. The legal effect of these resolutions was to recognize, affirm, and ratify the liability of the petitioner to its members for the amounts standing to the credit of the members in the various reserves under consideration. Furthermore, the effect of the resolutions of the board of directors was to set in motion the machinery necessary to apportion and designate the specific liability as to each member.

Particular reference is made to the resolution adopted December 21, 1936 (Exhibit 3, R., p. 135), wherein the board of directors specifically gave recognition to the equality of treatment between member and nonmember patrons in the declaration and payment of patronage refunds.

The other resolutions are found in Exhibits 3, 4, 5, 6, 7, 8, 9, 10, and 11 (R., pp. 136-145).

Attention is directed to resolutions adopted December 31, 1936 (Exhibit 5, R., p. 137), and December 31, 1937 (Exhibit 10, R., p. 143), in which patronage refunds were declared for the years 1936 and 1937, respectively. In these two resolutions for the aforesaid years, the patronage refund rates were declared on member and nonmember business, and, in each instance, the rate of refund for

the member patron was less than the rate of refund for the nonmember patron. The reason recited in the resolutions for the differential in refund rates between members and nonmembers, was that the portion of the members' refund, necessary to equalize the rates, was carried to the reserves and credited to the members' accounts. Part of the patronage refunds declared by these two resolutions were paid in cash and part were credited to the members' accounts in the reserves (R., p. 88). It is significant that in the same action the board of directors, in each year, apportioned and set aside the interest of the member, **whether the same was to be paid in cash or credited to his account, or both.** But, regardless of the manner or method of **payment** of the refund, the quality and character of the refund was the same in either instance. Therefore, it logically follows that patronage refunds declared by these resolutions immediately became liabilities of the petitioner regardless of the time of payment. No distinction can be drawn between the quality or character of the liability—whether acknowledged by payment in cash, or a credit to the reserve accounts. Furthermore, notice of the refund action was sent to each member (R., p. 81). Thus the petitioner acknowledged to the member its indebtedness to him.

Supplementing the action of the board of directors in the declaration of patronage refunds, the auditors and accountants of the petitioner carried into execution the authorization, by making appropriate ledger account entries as to each patron (R., p. 71). Exhibit 13 (R., p. 148) is typical of the meticulous care with which such entries, showing both debits and credits, were made. The ledger entries constitute unequivocal evidence of rec-

ognition of liability to the members for their respective interests in all of the reserve funds under consideration. No account book could more accurately set forth the debtor and creditor relation than do these ledger accounts of which Exhibit 13 is typical.

C. The Retention by the Petitioner of Patronage Refunds, Due Members, and Credited to Their Respective Accounts in the Reserves, Constitutes the Borrowing of Money and is a Capital Transaction, and Not an Income Transaction.

The temporary retention by agricultural cooperative associations of amounts due their members is a practice peculiar to this particular type of corporation. In order to more fully comprehend the issues in this case, and to make proper application of legal principles to the facts, it is well not only to examine the form of procedure, but also to ascertain the substance of the practice. In other words, it is essential to ascertain what primary objective is sought to be accomplished by this practice. Once the true nature, or the substance of the practice, is ascertained, the legal relationship existing between the association and its members can be more readily determined.

In substance, the practice of partial retention, by an association, of amounts due its members constitutes the borrowing of money. The only purpose underlying the plan of retentions and deductions is to enable the association to obtain operating capital, and capital for the acquisition of facilities.

The universality of the practice followed by agricultural cooperative associations in obtaining operating

capital from its members is well established and recognized. The following are excerpts from the Law of Cooperative Marketing, by Evans and Stokdyk. At page 164 it is said:

“As a means of securing subscriptions to capital, the membership fee is constantly declining in importance. This is for the reason that experience has shown that only nominal fees are satisfactory and that, after all, the most consistent and reliable source of revenue will arise from deductions or retains after the association is in operation.”

Again, at page 174 of the same work, it is stated:

“A common practice in dealing with membership contributions is to handle them in the form of revolving funds. This practice contemplates the repayment of the first contributions to capital when the desired amount of fixed and operating capital is obtained. It assumes, of course, that new contributions to capital will be made constantly.”

In the ordinary business corporation, capital is acquired in various ways, the most common being the issuance of stock, debentures, bonds, certificates of indebtedness, or similar obligations. Generally, these securities are offered to the investing public. Both the issuing corporation and the investor in such securities are aware that the proceeds thereof will be used, either for operations, or for the acquisition of capital assets by the issuer. By law, there is created a liability on the part of the issuer to redeem such securities, according to the terms and tenor thereof, up to the extent that the assets of the issuing corporation are available for this purpose.

Funds realized by a corporation from the issuance of its securities have never been recognized as income for

taxation purposes, under the various federal income tax acts. Regulation 94 of the treasury department promulgated under the 1936 Revenue Act, in Article 22, (a)-1, contains the following statement:

“In general, income is **gain** derived from capital, from labor, or from both combined, provided it be understood to include **profit**, gain through sale or conversion of capital assets.” (Emphasis ours.)

See also Article 22, (a)-16, Regulation 94, in which the following statement is contained:

“The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.”

See also Article 22, (a)-17, of Regulation 94, which contains the following:

“If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amount so received being credited to its surplus account, or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as addition to and part of the operating capital of the company.”

It is obvious that the petitioner, being a membership corporation, cannot obtain operating capital by the issuance of stock. We think it is equally obvious that the petitioner could not successfully issue bonds, debentures, or similar obligations for purchase by the invest-

ing public. Such investments would not be attractive to the general investor, who has no interest in, or knowledge of agricultural cooperatives. It necessarily follows that the petitioner, as well as similar agricultural cooperatives, must seek finances with which to conduct its operations from the class of persons most particularly calculated to be interested in the matter, to wit, its members. Loans, or advances, made to an agricultural cooperative association by its members, are not so made for the primary purpose of realizing a return on the investment, but for the purpose of enabling the association to provide an avenue whereby the members, as producers of agricultural products, may more effectively and economically market their farm products and purchase their farm supplies.

Consequently, the members of the petitioner, in becoming members, and in agreeing to be bound by the provisions of the articles of incorporation and the by-laws, have expressly agreed that, from time to time, they will make loans, or provide funds for the petitioner, necessary to afford adequate operating capital. To accomplish this purpose, it has been further agreed that, instead of the members making advances of cash, from time to time, the petitioner may retain funds of the members, in its possession, for operating capital. It is so expressly stated in their agreement. By its articles of incorporation (R., pp. 94, 95), the petitioner is expressly empowered to borrow money, to establish reserves, to levy assessments, and to use or employ any of its facilities for any purpose, and the proceeds arising from such use and employment shall go to reduce the costs of operation for its members. Retentions in the various reserve funds, and the liability to repay them

is recognized in Article VI of the articles of incorporation (R., p. 98). Specific authority for the retention of members' funds and the crediting of the same to reserves is detailed in the by-laws (R., pp. 113, 115, 125, 126, 127, 128, 129, 131).

If, at the end of each fiscal period, the petitioner had made a complete cash disbursement to its members as a repayment of these loans, there would be no question about the deductibility from gross income of such disbursements. If, immediately after such cash disbursements, or simultaneously therewith, the recipient member should tender back the moneys, as loans to the petitioner, the receipt of such advances by the petitioner would not constitute taxable income. The petitioner and its members have elected, as a matter of convenience, to omit this unnecessary detail. But, does the mere fact that these procedural details have been omitted in any respect change the character or the substance of the transaction? Scrutinized from any angle, and analyzed under all the circumstances, having in mind the ultimate purpose to be accomplished, we contend that the retention by the petitioner of the funds in the reserve accounts under consideration, constitutes the borrowing of money from its members, and that an absolute liability is imposed upon the petitioner to repay the same.

D. Creation of Liability Distinguished From Discharge of Liability.

It would appear that the error, upon the part of the Board of Tax Appeals, in applying the law to the facts in the case at bar, is the result of confusion, in failing

to distinguish the difference between the creation of a liability and the discharge of a liability, once created. The following excerpts are quoted from the findings of fact and opinion of the Board of Tax Appeals:

“No amounts credited to this reserve, pursuant to petitioner’s resolution summarized above, could be **paid** to any member or nonmember without authorization of the board of directors of the petitioner.” (R., p. 26.)

“The policy of the board of directors was to authorize **payment** to members whenever the financial condition of the petitioner was such that the amounts credited to the various reserve accounts could be **paid** to members without any detriment to petitioner. It was understood at all times that all moneys represented by the reserves, which were, in turn, credited to the various accounts of the members, could be used by the petitioner for any one of the purposes authorized in its by-laws. But if these amounts were to be used by the petitioner for **payment to members in cash or interest-bearing certificates** the **payment** had to be authorized by the board of directors of the petitioner.” (R., p. 27.)

“It is true that the petitioner credited to its patrons on its books an aliquot part of each of these reserves, but in each case further action of the board of directors was necessary before any portion of these reserves **could be made available to the members**. On the other hand, patronage dividends **in cash or certificates** could be distributed on authority of the resolution declaring them, without more.” (R., p. 31.) (Emphasis ours.)

Upon reading the opinion as a whole, and particularly the excerpts quoted above, it becomes readily apparent that the Board of Tax Appeals was of the opinion that further corporate action was necessary to be taken by the petitioner, in order to **create liability** on the part of the petitioner to its members for the amounts credited to their accounts in the reserves. Herein lies the error.

It has been demonstrated that under the facts in the instant case, and the law applicable thereto, fixed, definite and certain liability was created against the petitioner through its articles of incorporation, by-laws, corporate resolutions, and contract with its members. It is conceded that further corporate action was necessary in order to authorize the **payment** of these liabilities to the members. The by-laws specifically provide that certificates of members' interest shall be retired, and payments of reserve funds shall be made to the members upon authorization of the board of directors (R., pp. 126, 128, 130, 131). Properly interpreted, this simply means that the **time of the discharge** of the liability shall be determined by the board of directors. The liability definitely **created**, as above indicated, is subject to **discharge** upon determination and authorization by the board of directors.

The maker of a promissory note **creates** liability when he executes the note; he **discharges** that liability when he pays the note. A debtor vendee **creates** liability, when he purchases goods from a creditor vendor; he **discharges** liability when he makes payment to the creditor. The character of the liability is in no manner altered by reason of the fact that the time of its discharge is subject to the determination of the debtor. There is nothing unusual about this. The discharge of a liability may be at a future time certain, or at a time determined by some future act.

Under the Federal Income Tax Law, the deduction of a liability from gross income is allowable if the liability is **created** during the taxable year. The fact that the liability, **created** within the taxable year, is **dis-**

charged subsequent to the taxable year, does not alter this rule.

Farmers Union Coop. Assn. v. Commissioner of Internal Revenue, 13 B. T. A., 969;

Home Builders Shipping Assn. v. Commissioner of Internal Revenue, 8 B. T. A., 903;

Anamosa Farmers Creamery Co. v. Commissioner of Internal Revenue, 13 B. T. A., 907;

Midland Cooperative Wholesale v. Commissioner of Internal Revenue, 44 B. T. A., 824.

G. C. M. 17895—C. B. 1937—1, p. 56, a portion of which is quoted as follows:

“Patronage dividend may be excluded in determining the amount of undistributed net income subject to tax * * * provided the **liability therefor is set up on the books of the cooperative organization** pursuant to corporate action taken with respect thereto prior to the close of the particular accounting period.” (Emphasis ours.)

E. Erroneous Application, by Board of Tax Appeals, of Authorities to Facts in Case at Bar.

In the opinion of the Board of Tax Appeals, in the instant case, its decision, sustaining the commissioner of internal revenue, is predicated upon several reported cases, cited in the opinion (R., pp. 29-31). A careful examination and analysis of the cited authorities clearly indicates an erroneous application of them to the facts in this case.

In **Fruit Growers Supply Co. v. Commissioner of Internal Revenue**, 21 B. T. A., 315; affirmed 56 Fed. (2d), 90 (CCA 9); patronage refunds accrued to the account of the patrons only when, and if, authorized by the board of directors. Under the terms of the by-laws, there could be no automatic accrual of refunds, nor could

individual credits be set up on the records to the account of the members. The Board of Tax Appeals properly held that under the circumstances corporate action by the board of directors was necessary before refunds were realizable or accrued. An analysis of this case develops the fact that declaration of refunds, as distinguished from the payment of the refunds, was the important element controlling the allowability of deductions of such sums from gross income.

In affirming the Board of Tax Appeals, the Circuit Court of Appeals, at page 93 of its opinion, say:

“Until ‘patronage dividends’ are declared they have not accrued as obligations from the corporation to its members.”

In **Farmers Union Co-op Co. v. Commissioner of Internal Revenue**, 90 Fed. (2d), 488 (CCA 8), there was no requirement, in the articles of incorporation or the by-laws, for automatic apportionment of surplus income to the credit of individual members. The petitioner sought to claim as allowable deductions from gross income, the net undistributed and unapportioned surplus earnings, on the general theory that its cooperative form of operation fixed title in the net surplus in the members, to the exclusion of the corporate entity.

At page 491 the court in its opinion, say:

“This argument would acquire force and would require examination here if such were the situation of the petitioner. The reason why such argument is not here applicable is that the distribution of earnings was not required by the governing statutes, the articles of incorporation, or the by-laws to be confined to patrons. In fact, the statute permitted such earnings to be partly diverted to holders of shares of stock; * * *.”

In **Cooperative Oil Association v. Commissioner of Internal Revenue**, 115 Fed. (2d), 666 (CCA 9), the articles of incorporation and by-laws contained a general provision for the distribution of net earnings to the stockholder patrons. The determination, however, of such refunds was subject to declaration by the board of directors, before liability of the petitioner was established. There was no automatic accrual to members of refunds. It was the practice of the directors only to declare the specific refunds actually paid to the members. The remainder of the savings was placed in an undistributed reserve account without any specific allocation of credits to members. The court held (at page 668), that the undistributed surplus or earnings which had not been declared as patronage refunds, or apportioned to the members, and for which no specific allocation was made to the members on its records, could not be allowed as a deduction from gross income.

The case of **Midland Cooperative Wholesale v. Commissioner of Internal Revenue**, 44 B. T. A., 824, strongly supports the position of the petitioner in the case at bar. In that case, under the provisions of the articles of incorporation and the by-laws, the directors declared patronage refunds, part of which were paid in cash, and part were placed in reserves. Both the portion of the refunds paid in cash and the portion held in reserve were allocated to the patrons at the same time, and entered upon the corporate ledgers as credits to individual members. Both were computed upon the business transacted with the association, and hence were accrued liabilities. It was held that no further, or additional, corporate action was necessary to create liability on the part of the petitioner to its members.

Not by the widest stretch of logic or reasoning can the rule announced in **Corliss v. Bowers**, 281 U. S., 376, be made applicable to the instant case. The rule therein was limited, strictly, to the taxability of income by the recipient or potential recipient thereof. Under the specific facts before the court, it was held that income of a revocable trust estate was taxable to the donor of said estate, even though the same was actually received by the beneficiary, because the donor had the right to receive the income, whether or not he actually saw fit to receive it. The Corliss case simply determined under what circumstances a recipient or a potential recipient of income, was subject to taxation thereon. In no respect does the court attempt to prescribe any rule applicable to the taxable status or liability of the payor of the moneys which were the subject of income by the recipient or potential recipient thereof.

V.

CONCLUSION.

From the record as a whole, it is apparent that the petitioner had no net income subject to federal income tax for the years 1936 and 1937. The funds credited to the "Reserve for Security of Membership", the "Reserve for Zoning Hazard", and the "Reserve Against Loss by Overpayment", were not income of the corporate entity, but constituted loans, or operating funds, advanced to the petitioner by its members. By contract between the petitioner and its members, as evidenced by the corporate articles of incorporation and by-laws, and by corporate action as evidenced by the resolutions of its

board of directors, a definite legal liability was created on the part of the petitioner to its members for the amounts credited to the aforesaid reserves. The commissioner of internal revenue should, therefore, either have permitted the amount of said reserves to be excluded from gross income of the petitioner, or, if included, to be allowable as deductions from gross income for the years in question. We submit that the order and judgment of the Board of Tax Appeals should be reversed.

Respectfully submitted,

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Dated, Columbus, Ohio,

December 7, 1942.



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No. 10,246

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS
ASSOCIATION,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONER.

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REPLY BRIEF FOR PETITIONER.

In its brief, petitioner pointed out that the amounts involved in this proceeding were not income to the petitioner, that they belonged to the individual producer members in proportion to their patronage, that they had been recognized by petitioner as accrued liability to the respective producers and had been appropriated and credited as an obligation to each individual producer in proportion to his patronage and so were proper deductions from gross income. In addition, petitioner was entitled to have been recognized as an exempt association.

Respondent in its reply brief has contended:

1. That petitioner is not tax exempt since (a) it realizes profit from its business with non-members, and

(b) there is no evidence that the reserve funds are reasonable reserves.

2. That the amounts placed in the reserves constitute income to petitioner and not to its members. Further that such amounts cannot be deducted from gross income since they have not been returned to patrons and since such deductions are solely a matter of administrative grace.

Even though petitioner were not an exempt corporation, the amounts concerned were not net income to it. They belonged to the member patrons and had been appropriated to them. Therefore petitioner will first consider respondent's contentions as to this.

1. RESPONDENT ERRS IN HIS CONTENTION THAT THE AMOUNTS IN QUESTION CONSTITUTE INCOME TO THE PETITIONER AND DO NOT BELONG TO THE MEMBER PATRONS.

In all of the decided cases, even those cited by respondent, the question as to the nature of the funds was decided by the particular facts. These involved the Articles of Incorporation and By-laws of the association concerned, the statute under which it was organized as well as the acts of the association itself. The statutes under which this association is organized are noted in petitioner's brief (p. 12) and clearly provide that its operation shall be without profit to the association. The Articles of Incorporation of petitioner recognize this limitation (R. 95). The By-laws distinctly provide that the net proceeds belong to the

members (R. 124). This refers to all net proceeds whether they result from marketing or purchasing.

The Courts of California have specifically recognized that under such statute and such an organization the net proceeds belong to the members. Respondent's brief (p. 25) has incorrectly characterized the effect of *Bogardus v. Santa Ana Walnut Growers Association*, 41 Cal. App. (2d) 939, 108 Pac. (2d) 52. In that case the plaintiff did not seek to recover amounts due but sought to have a declaration of rights that other growers had no interest in the funds. The California Court held that under the cooperative statute these net proceeds were trust funds which belonged to the members who contributed their products in proportion to their contribution and that they remained the property of such persons even though they were not presently distributed. This clearly distinguishes this situation from those cases cited by respondent.

The decision in *Farmers Union Cooperative Company v. Commissioner*, 90 Fed. (2d) 488, was based upon the particular statute and by-laws concerned and the particular facts of that case. The Court there pointed out that the statute and the by-laws permitted earnings to be diverted to members or stockholders as such rather than to them as patrons. Section 1192 of the Agricultural Code of California specifically declares that they are not to have profit for themselves or for their members as members. That decision recognized that there would be a serious question whether these proceeds would constitute income within the Income Tax Amendment if the association there con-

cerned had been organized and operated on a cooperative basis. Here there can be no question as to the organization of this association on a cooperative basis nor as to its operation. That was conceded by respondent (R. 29). The other cases cited by respondent (p. 19) are clearly distinguishable from this case on the facts. They do not set down the general rule that proceeds belong to the association but looked to its organization and operation to determine this.

The By-laws of petitioner specifically state that net proceeds are the property of its member patrons and the By-laws constitute a contract with them. Every act of petitioner was in recognition of this situation. When the member joined the association, he was specifically advised that these net proceeds belonged to him (R. 146). He was advised that they might be used in reserve funds, and if they were, appropriate credit would be given to him for the amounts placed therein from the net proceeds belonging to him. The By-laws authorized the directors to create and maintain reserve funds, but the monies placed into these funds are the monies that belong to the producers who are entitled to the same and who have authorized and assented to their being placed in such reserve funds. The money so placed therein was not income to the petitioner. It was money belonging to the producers which they permitted the association to use. If the Board of Directors had attempted to use these funds for any other purpose than to place the same in duly authorized reserve funds, the individual producer would unquestionably have had a cause of action against the

association and would have been entitled to have immediate payment of the funds not used for the purpose assented to by him. The fact that the member permits this use of his portion of the net proceeds does not deprive him of these funds. He is permitting their use for working capital and is in the same position as if he had advanced that sum to the association from other sources and had received the association's promise to repay this advance in the due revolving of the fund into which it was paid. That is not income to the association. It is an indebtedness or liability which the association has concretely and explicitly recognized.

2. RESPONDENT ERRS IN CONTENDING THAT THE AMOUNTS PLACED IN THESE RESERVE FUNDS WERE NOT DEDUCTIBLE AS PATRONAGE REFUNDS.

Respondent in support of its argument has here made the astounding statement that deductions of patronage refunds are solely a matter of "*administrative grace*" (italics ours) (Br. p. 22). Such a contention is destructive of our Democracy. Petitioner seeks these deductions as a matter of right because they do not represent true income of the association. They added no riches to petitioner because petitioner was under an accepted liability to pay them to the member patrons in the amounts credited to them. The allowance as deductions of the amounts appropriated for and declared as patronage refunds is based on the fact that these amounts really belong to the member patrons and constitute an indebtedness of the associa-

tion to them. Such amounts cannot be classified as income and are not taxable (Pet. Br. pp. 18, 19). It is because they are a liability of the association that they are recognized as deductions and this is not a matter of administrative grace. The Board of Tax Appeals in *Midland Cooperative Wholesale v. Commissioner*, 44 B. T. A. 824, 830, acknowledged that such deductions could only be allowed on that basis. It was not because of an official's whim. No one of the cases cited by respondent has ever expressed the view that these deductions were a matter of administrative grace. Congress has not delegated to any administrative official the authority to make that income which has heretofore been recognized as a liability and not income. In fact such a delegation of legislative power would clearly be unconstitutional (*United States v. Schechter Poultry Corporation, et al.*, 295 U. S. 495, 79 L. Ed. 1570). Yet respondent apparently assumes and exercises such power as a matter of administrative grace.

Respondent further argues that deductions are not permitted unless the amounts in fact have been returned to members during the taxable year (Br. p. 22). The cases he cites do not support this statement. The cited cases only required that the right to patronage refunds should have been declared.

In this case, the amounts claimed as deductions belonged to the member patrons by their contract with the association, and such amounts had been recognized as their property and as a liability of the petitioner

to them by resolutions of the Board of Directors, by book entries and by specific acknowledgment to the member patron through a written statement.

The amounts here in question were declared as part of the patronage refunds for the respective years 1936 and 1937. The resolutions of the Board (R. 137, 143) specifically recognized these amounts carried to reserves as an additional part of the patronage refunds belonging to member patrons and payable to them. Whether the producers received certificates or statements of indebtedness as acknowledgment of the liability of the association to them, it made no difference insofar as the individual member patron was concerned. The liability existed. The funds had been prorated to their credit and the obligation of the petitioner to them was definite in amount. No further action was required by the Board of Directors to make this liability or obligation complete (R. 74). The General Manager testified (R. 73) that if the funds in these reserves were expended for any purpose, the amounts represented still remained the property of the members and it would not affect the liability of the petitioner to them. This is the very essence of the revolving fund theory of operation. The funds provided by present members for capital purposes or working purposes may be so used and then as subsequent funds are provided by newer members, the earlier funds are paid out. The liability is always there. The time of payment depends upon the convenience and availability of cash funds for that purpose.

Respondent argues that until the proceeds are distributed, patrons have no greater interest in them than stockholders have in undistributed earnings of a corporation. This is not the fact. When the net proceeds have been determined, they belong to the member patrons not as members but as patrons and are held in trust for them by the petitioner. When the Board authorized, as it did, the appropriation and crediting of the respective sums to the member patrons, it created a liability to them which constituted them general creditors of petitioner to the amount of the refund due them. *Farmers Union Cooperative v. Commissioner*, 90 Fed. (2d) 488, recognizes that this interest ripens into ownership when the refund is declared.

Respondent is in error in stating that the existence and extent of the liability was not fixed by action of the taxpayer in the taxable years involved but was contingent upon future events (Respondent's Br. p. 24). The existence and extent of the liability was immediately fixed in the taxable years involved. The time of payment was deferred but this did not affect in any manner the right to the payment or the amount which the member patron would be entitled to receive. *Commissioner v. Brooklyn R. S. Corporation*, 79 Fed. (2d) 833, is of no authority here, for in that proceeding the bonus claimed by the General Manager was not entered on the books. Here the amounts were immediately entered on the books to the credit of the individual members. The Court there said that the test is whether the taxpayer is justified in entertaining a reasonable expectation that an expense would be

incurred or payment made in due course. Here there can be no question that the taxpayer expected to pay out these amounts to its members in due course. It was solvent, its operations each year were increasing and it had never failed in its obligations to its members so that there was no question that it had the right to expect that in due course these amounts would be revolved to the patron members in the amounts for which they had been credited and for which it was indebted.

Respondent states that *Midland Cooperative Wholesale v. Commissioner* (supra) is distinguishable but respondent has not been able to deny the facts quoted in appellant's brief (pp. 30 and 31) which show that there is no distinction between the cases. The amounts held in reserves, similar to amounts held in reserve in this case, were held to have been allocated to the individual members and not to be income of the association even though held in reserve. A careful reading of the cases shows that there is no distinction between the situations. The Board in the *Midland* case held there was no further corporate action necessary to create a liability and so it was not income. Here likewise no further corporate action was required to create the liability. All such action had been taken and the liability existed and was of record. If deductions are to be a matter of legal right and not of administrative grace, then upon the basis of that decision alone, the decision of the Board of Tax Appeals must be reversed.

CONCLUSION.

Respondent in his administrative capacity has classified as income net proceeds which belonged to member patrons and did not inure to the benefit of petitioner. These net proceeds were unequivocally acknowledged as a liability of petitioner to the individual producers in specific amounts as entered on the books of petitioner. The producers permitted such funds to remain with the petitioner as working capital. Such funds became part of revolving funds which would revolve so that the sum then definitely fixed and credited in the years in question would be paid to the producer. These amounts remained constantly an indebtedness of the petitioner to the individual producer. As a matter of right and not of administrative grace, petitioner submits that it is entitled to have these amounts recognized for what they were, amounts belonging to the producers, and not as net income of the petitioner.

Petitioner respectfully submits that the decision of the Board of Tax Appeals should be reversed.

Dated, San Francisco,
December 18, 1942.

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No. 10,246

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS
ASSOCIATION,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

**MOTION FOR LEAVE TO FILE BRIEF AS AMICI
CURIAE AND BRIEF.**

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FILED

JAN - 5 1943

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IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS
ASSOCIATION,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MOTION FOR LEAVE TO FILE BRIEF AMICI CURIAE.

The undersigned, counsel for Messrs. Wayne E. Mayhew and Herman G. Brissman, certified public accountants, respectfully move the Court for leave to file herein the annexed brief *Amici Curiae* herein.

Both counsel for petitioner and for respondent have expressed their consent to its presentation.

Messrs. Wayne E. Mayhew and Herman G. Brissman are certified public accountants doing business as Mayhew, Brissman & Company, having their principal office in the Kohl Building, San Francisco, with branch offices in Chicago and Portland. A substantial part of their work consists of cost accounting for, and auditing the books and affairs of, various cooperative associations. They have

acquired a familiarity with the problems of cooperatives, particularly in the field of finance and taxation.

The problem here presented is, they believe, of vital interest to all cooperatives and of great public importance. It will seriously affect the future welfare and operations of all cooperatives. It is for this reason that this brief has been prepared in the hope it will assist the Court to reach the right conclusion.

Dated, San Francisco,
January 4, 1943.

Respectfully submitted,

W. GLENN HARMON,

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Public Accountants, As Amici
Curiae.*

No. 10,246

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BRIEF AMICI CURIAE.

PRELIMINARY STATEMENT.

No attempt is made to fully outline the facts developed by the evidence herein, but rather merely to deal with the more general aspects which are of interest to the entire cooperative movement. The petitioner herein, San Joaquin Valley Poultry Producers Association, was organized in 1925 under the provisions of the Agricultural Non-Profit Cooperative Marketing Association Act of California, Secs. 1191-1221, Agric. Code of the State of California, formerly contained in Title XXIII of the Civil Code of the State of California (Secs. 653aa-653xx) as a non-profit cooperative having no capital stock but charging a nominal membership fee of \$10.00. It did some business with non-members, but not very much proportionately, and although non-members did not share in "patronage divi-

dends'' they were paid at a higher cash rate than members for their products in order to equalize matters. The funds here involved were derived from deductions from proceeds of sales of members' products and overcharges from purchases on behalf of members. These were placed in certain reserve accounts. Pursuant to resolution of the directors, each member was credited individually on the books with the amounts kept from him under a revolving fund plan whereby the association would keep the funds for a period of time, then return them to the member, replacing them as needed with later funds similarly derived.

These funds are sought to be taxed herein as income to the cooperative, the reason given being that they are the property of the cooperative since the members cannot withdraw their respective shares at will without further action by the board of directors.

Such revolving funds are not at all unusual among cooperatives, particularly non-stock cooperatives; they are one of the few possible ways of raising capital. It is well settled that such funds actually returned to the members within a tax year are not income taxable to the association. The particular issue here presented is whether such funds kept by the association beyond the tax year as a revolving fund ultimately to be returned to members on a patronage basis are to be treated likewise. It is this point which is of prime interest to all non-profit cooperative associations, and it is to shed what light we can upon it that this brief is being filed.

There has been inevitably some confusion in thinking on this subject, natural enough in the process of developing the comparatively new field of cooperative law. But the

underlying principle which governs taxability is, we think, clearly defined and upon it the cases can be pretty well reconciled. Properly understood, they disclose that neither the time nor the actual form of payment is the important thing; rather, it is the existence or non-existence of a definite liability on the part of the association to its members for the return of the moneys on the basis of volume and value of products handled. Where this liability exists, either by virtue of the fundamental law of the association's creation, such as statute, charter, or by-laws, or by virtue of appropriate corporate action such as resolution or book entries, the funds are not income to the association and are not taxable to it. It is only where this liability is not fixed and clear, that the funds are to be considered as property of the association and hence taxable to it.

ARGUMENT.

I. THE BOARD ERRED IN HOLDING THE RESERVES HAD TO BE AVAILABLE AT PATRONS' "UNFETTERED COMMAND" BEFORE THEY COULD BE DEDUCTED FROM PETITIONER'S INCOME TAX RETURN.

Because the reserves in question were not payable to patrons at the latter's "unfettered command"¹ the Board has ruled herein that the patrons' interest had not ripened into ownership and therefore that the funds belonged to the cooperative and were taxable income to it.

There are two errors in this ruling: First, it ignores completely the possibility of an agency and trust relation-

¹The phrase is borrowed by the Board from *Corliss v. Bowers*, 281 U.S. 376; it involved taxability to the donor of income from a revocable trust. The case has no bearing here.

ship between the cooperative and its members, assuming that beneficial ownership can exist only where the owner has the right to immediate possession and control of the subject-matter,² and second, it assumes that for the cooperative to be entitled to deduct the funds from its gross income, the funds must be *owned* by the patrons, that it is insufficient for the cooperative merely to be obligated to the patrons therefor, unless at least the obligation has ripened into the right of immediate possession.

It is this last erroneous assumption we discuss under this subdivision of our brief. We point out here that as there was an obligation to account to the members for these funds on the basis of the sales and purchases of the individual member, the funds are not taxable, (1) because they do not constitute taxable income and (2) because they are deductible under Section 101 (12), *Revenue Act* of 1936. (49 Stat. 1648.)

(1) The obligation to account to its members for these funds is clear and under Article VIII, sec. 1 of its by-laws (R. 125), and under the special resolutions by the directors. (R. 136-142.) The existence of this obligation as that of an agent, or at least as a borrower, is more fully discussed under Point II. Here we point out that given the obligation, whatever it be denominated, the moneys received under it do not constitute taxable income under the *Sixteenth Amendment*.

Mertens, Law of Federal Income Taxation, Vol. 1,
Sec. 5.24;

William H. Stayton, Jr., 32 BTA 940;

Lorenzo C. Dilks, 15 BTA 1294.

²This is discussed under Point II, *infra*, pp. 17-29.

(2) As to the second point, the amounts that the cooperative is obligated to repay its members are exempt under sec. 101 (12) of the *Revenue Act*, supra, because as hereinafter pointed out, this exemption was incorporated in the statute by Congress by its ratification of administrative rulings and decisions by the Board of Tax Appeals allowing such deduction thereunder.

Our argument hereunder deals with both of these concepts set forth in both (1) and (2) above.

While respondent now concedes (Brief, p. 22) that payment to patrons need not actually take place within the tax year, the Board rules that if the cooperative is to escape taxation the patron must have the *right* to withdraw when and if he wishes. Thus, in effect, it draws an unwarranted distinction between demand obligations and all others, ruling that the latter may not legitimately be deducted from gross income, whereas the former may; and it gives an unjustified emphasis to the time of *payment* of obligations as distinguished from time of *creation* of obligations that has never before occurred.

For obvious reasons, the accumulation of reserves subject to such withdrawal at a patron's will is rare indeed, since such funds would be of no practical value to a cooperative because it could not control them in its time of need. Yet never until the present case, so far as we have been able to find, has the taxability to a cooperative of such funds turned upon whether the patrons could withdraw them at will. None of the cases cited to support the conclusion (*Fruit Growers Supply Co. v. Commissioner*, 56 Fed. (2d) 90, Aff'g 21 B.T.A. 315; *Farmers Union Co-Op v. Commissioner*, 90 Fed. (2d) 488; *Cooperative Oil*

Assn. v. Commissioner, 115 Fed. (2d) 666) actually do so, each being decided upon the lack of existence of an obligation rather than on the right to demand immediate payment.³

In creating the distinction, the Board has failed to appreciate and apply the principles underlying cooperatives, substituting the superficial test of "unfettered command" for a real inquiry into the nature of these funds to determine if they truly fall within the definition of taxable income or the exemption of sec. 101 (12) of the *Revenue Act*, supra. The result, besides ignoring basic principles, constitutes discrimination against cooperatives.

The case of *Penn Mutual Life Ins. Co. v. Lederer*, 252 U.S. 523, explains the fundamental principles involved. This decision has been misunderstood, for although the Board's present conclusion is at variance with it, the case (Penn Mutual) is cited by the Board as supporting its ruling. (R. 30.) The case is cited as holding that an insurance company could not deduct from its gross income payments "which had not been actually repaid to them [policyholders] or credited to them within the taxable year". (R. 30.) It is respectfully submitted that such was not the holding of the case, the point not even being before the Court. The funds there involved had all actually been paid or credited to the policyholders within the taxable year. Thus, there was no presentation of or decision upon the question whether or not payments had been actually paid or credited within the taxable year. The controversy arose over the insurance company's claim of the right to deduct from its gross income *all* of the funds it had paid

³For further discussion of these cases see *infra*, pp. 16-17, 27-29.

or credited within the tax year, whereas the government contended it could not deduct the part coming from profits on investments, but only that part going to reduce the cost of protection. The Court ruled with the government.

The *Penn Mutual* case is pertinent here, not on the point for which it was cited by the Board, but because the Court therein stated the governing principle which underlies exemptions of this sort, namely, the distinction to be drawn between funds which are actually returns or profit from investments and properly subject to tax, and funds which are strictly in the nature of a reduction in cost of service to a patron and which are in no sense income because they must be accounted for to the patron. The Court discussed at length the dual nature of an insurance company, one phase pertaining to investment and the other to protection. It held that the portion of premiums returned to policyholders as reduced cost of protection was not properly to be considered income to the company; whereas dividends to policyholders representing earnings upon investment were income and properly subject to tax.

This, then, was the basis upon which deduction or taxation was determined, and not whether the funds had or had not been paid over in the taxable year.

The distinction is important for we have here the same type of exemption, although a different exemption statute. The fundamental inquiry here is simply as to the *nature* of these funds i.e., whether they constitute taxable income, and not as to the time of payment or the right of the patron to control them.

The test heretofore consistently relied on to determine this inquiry is, first, determine if a liability exists within

the taxable year for an accounting of these funds;⁴ second, if so, determine whether the accounting is to be to *stockholders* on the basis of their *stockholdings* (in which event it is a return on invested capital and its income nature is clearly established), or whether the accounting is to be to patrons on the basis of volume and value of patronage (in which event it represents a reduction in cost or an overpayment and is not taxable income.)

This is illustrated in *Mutual Benefit Life Ins. Co. v. Herold*, 198 Fed. 199, aff'd 201 Fed. 918, cert. den. 231 U.S. 755, cited with approval in *Penn Mutual Life Ins. Co. v. Lederer*, *supra*. The Court ruled that "dividends" returned to members as a reduction on the subsequent premiums were not income, saying (page 205):

"This excess payment represents, not profits or receipts, but an overpayment—an overpayment because, being entitled to his insurance at cost and having paid more than it costs, he is equitably entitled to have such excess applied for his benefit. It makes no difference what this excess is called. The question is, what does it represent? Does it in anywise or to any extent represent earnings or profits received by the Company, so as to constitute it a part of its income; or does it merely represent an overpayment?"

⁴In *Farmers Union Coop Co. v. Commissioner*, 90 Fed. (2d) 488, *supra*, the funds were taxed because no liability existed. In *Cooperative Oil Assn. v. Commissioner*, 115 Fed. (2d) 666, *supra*, it was likewise found that the liability did not exist. In the following Board cases deduction was allowed because the liability did exist within the tax year even though not discharged by payment: *Midland Cooperative Wholesale Assn. v. Commissioner*, 44 B.T.A. 824; *Anamosa Farmers Creamery Co. v. Commissioner*, 13 B.T.A. 907; *Farmers Union Coop Assn. v. Commissioner*, 13 B.T.A. 969; *Home Builders Shipping Assn. v. Commissioner*, 8 B.T.A. 903.

See also, *Uniform Printing & Supply Co. v. Commissioner*, 88 Fed. (2d) 75; *Board of Fire Underwriters*, 26 B.T.A. 860; Cf. *Producers Creamery Co. v. United States*, 55 Fed. (2d) 104; and *Farmers Union Co-op Co. v. Comr.*, 90 Fed. (2d) 488, 491, *supra*.

This difference between profit from investment and return of overpayment or reduction in cost has been recognized consistently from the first. On this theory in Regulation 45, Art. 522, it is provided that though cooperatives acting as purchasing agents were not specifically exempt, nevertheless, their rebates to purchasers should be excluded from gross income. In I.T. 1499, C.B. I-2, page 189, this was extended even to cooperatives organized to do business at a profit (quoting from Article 75, Reg. 33):

“ ‘If amounts paid to members are based solely upon quantity of produce furnished, such amounts may be deducted from the gross proceeds of sales, and the taxable net income will be the amount of earnings passed to surplus, or distributable among members upon the basis of stockholdings.’ ”

In other words, only that portion which passed unquestionably into the hands of the corporation as its own property and thereby became distributable to its stockholders on the basis of their stockholdings rather than on a patronage basis has been considered as belonging and taxable to the association. This decision further said of such rebates (quoted from T.D. 2737, June 19, 1918):

“ ‘Like discounts generally, they should appear as an added item of cost in the detailed schedule of cost items submitted with the organization’s returns of income.’ ”

“ ‘The ruling is in accordance with settled practice in the administration of the income-tax laws, adopted because the real purpose of such organization was to furnish goods at cost’ * * *

“ ‘This office has consistently held that under the Treasury decision and articles of the regulations referred to, cooperative associations even though not exempt from taxation, may deduct from gross income for the years 1917, 1918, 1919 and 1920 the amounts returned to their patrons, whether members or non-members, upon the basis of the purchases or sales, or both, made by or for them. This is upon the theory that a cooperative association is organized for the purpose of furnishing its patrons goods at cost or for obtaining the highest market price for the produce furnished by them. * * * ’ ”

The growth of the treatment accorded reserves is particularly pertinent because that is the type of funds here involved. They were not specifically included in the first exemption statutes; nevertheless, cooperatives were permitted to accumulate them with no thought of taxation. In S.M. No. 57, C. B. 3, page 241 (1920), there was a larger surplus than usual accumulated for 1918 which was not prorated back to the farmers at the close of the year because of uncertainty of the amount of taxes and also because it was desired to improve the cooperative property; some of the funds were used to purchase real estate upon which to build a loading station and were thus quite obviously beyond the patrons’ “unfettered command”. Neither the fact that this particular cooperative had capital stock (the return on which was limited), nor of its having kept and used the surplus in the manner indicated, deprived it of exemption. The solicitor said:

“The language of subdivision 11 of section 231 is very broad. It was undoubtedly the intention of Congress that a bona fide sales agent for a group of farmers should be exempt from tax. There is no clause in the paragraph which would bar from exemption a corporation of the character of the N Company.”

That ruling has never been departed from. The solicitor distinguished the case from two previous decisions wherein tax had been levied upon reserves because under the facts those reserves became the property of the stockholders rather than of the patrons.

Another case squarely in point arising under the *Revenue Acts of 1918 and 1921*, but not decided until 1924, is S.M. 2288, C.B. III-2, page 233. Part of the taxpayer's savings were set aside as a reserve to finance its operations but remained as credits to the patrons in proportion to their purchases and could not inure to the benefit of the stockholders, since they had no claim beyond their limited dividend. It was, therefore, held exempt from tax. Still another case arising under the same act is S.M. 2286, C.B. III-2, page 236, where the cooperative kept back from members and under its own control a reserve to take care of its selling organization and to tide it over lean years. The memorandum says:

“Relative to the reserve, it should be noted that it stands to the credit of subexchanges and local associations and through them to the credit of the individual growers in the very proportion in which fruit is furnished by them, so that such part of the reserve as is not needed to meet losses will *ultimately* revert to the growers *to whom it essentially belongs*.” (Emphasis supplied.)

In 1921 this ruling as to reserves was incorporated in Regulation 62, Article 522, which specifically provided that accumulation and maintenance of a reasonable reserve for stated purposes would not destroy the association's exemption. Nothing in the regulation indicates that the reserves had to be payable to members on demand; indeed such a requirement is repugnant to the very concept of reserves.

Whether this administrative attitude was right or wrong, it was ratified by Congress itself. The exemption statute was amended in 1921 (See 231 (11) Revenue Act of 1921) to encompass the administrative rulings extending the exemption to purchasing agents as well as sales agents; and in 1926 to further broaden the exemption generally to accord with the administrative practice. The Committee report on the 1926 amendment (S. R. 52, Senate Committee on Finance, 69th Congress, 1st Session) commends and adopts the liberal attitude toward the exemption in the following language:

*“The existing law, strictly construed, allows exemption only to those farmers’, fruit growers’, or like associations which act as sales or purchasing agents for producer members and which return to such members the entire proceeds of their operations, except necessary sales or purchasing expenses. However, in order that any such association, not operated for profit, and which is a true cooperative association, shall get the benefit of this exemption, the Treasury Department in its regulations has construed the existing law with great liberality, * * **

“The committee amendment does not broaden the scope of nor even include all the provisions of the Treasury regulations but only incorporates certain

provisions adopted by the Department as fundamental in allowing exemptions to cooperative marketing and purchasing associations. The amendment will assure associations, now exempt, that the liberal construction, by the Department, of existing law, is sanctioned by Congress and if enacted will prevent a valid, but perhaps sudden or drastic, restriction upon exemptions, such as is now possible under existing law.''' (Emphasis supplied.)

See Mimeograph No. 3886, C. B. X-2, 164, July 9, 1931.

These administrative practices thus became the law through Congressional ratification. *Silas Mason Co. v. Tax Commission*, 302 U.S. 186; *Swayne & Hoyt v. U. S.*, 300 U.S. 297. Even where there is no direct ratification, if such is the fair implication of the Congressional action it is sufficient. *Hamilton v. Dillin*, 21 Wall. 73; *Mattingly v. District of Columbia*, 97 U.S. 687; *Wilson v. Shaw*, 204 U.S. 24; *Charlotte Harbor & N. R. Co. v. Welles*, 260 U.S. 8. So that here, though in the amended statute the Committee literally incorporated only fundamentals, leaving out broad details, the re-enaction of the statute with these amendments, read in the light of the committee's statement, must be considered as an approval of the practices as a whole. None of the Treasury rulings were disapproved.

Following the amendment of 1926 the Board of Tax Appeals has repeatedly followed the same liberal principles, specifically granting deductions in cases analogous to the one here. *Home Builders Shipping Assn.*, 8 B.T.A. 903 (decided in 1927 but involving tax year 1919); *Anamosa Farmers Creamery Co.*, 13 B.T.A. 907 (decided in

1928 but involving tax year 1925); *Farmers Union Cooperative Assn.*, 13 B.T.A. 969 (decided in 1928 but involving the tax year 1920); *Midland Cooperative Wholesale Assn.*, 44 B.T.A. 824 (decided in 1941 but involving the years 1936 and 1937.)

During these years new revenue acts have repeatedly been passed, but never has there been an amendment to override the decisions of the above cases or the administrative practices out of which they grew. This of itself would amount to legislative approval. *Helvering v. Winmill*, 305 U. S. 79, 83; *U. S. v. Dakota Montana Oil Co.*, 288 U. S. 459, 466; *Old Mission Portland Cement Co. v. Helvering*, 293 U. S. 289, 293-4; *National Lead Co. v. U.S.*, 252 U. S. 140, 146.

Thus, Congress has approved a liberal construction of this exemption as a matter of policy. In Point III herein, we show that it is an important part of public policy to favor cooperatives. While exemption and exclusion provisions are generally strictly construed, such provisions begotten of motives of public policy as here involved are not to be so treated. *Helvering v. Bliss*, 293 U.S. 144, 150-151; *United States v. Pleasants*, 305 U.S. 357, 360 aff'g. 22 F.S. 964, 971; *McFeely v. Commissioner*, 296 U.S. 102, 111.

Thus, contrary to the ruling of the Board (R. p. 32) and the claim of the Government (Brief, p. 22) the taxpayer herein is not dependent upon "administrative grace" to support its contentions. This idea evidently comes from certain language used by this Court in *Cooperative Oil Association v. Commissioner*, 115 Fed. (2d) 666, wherein the Court said: "Petitioner does not set forth any theory as to what statute authorizes the deduction even if its

contentions are sound", but "in effect asked [the Court] to hold that an administrative practice permitting a deduction not authorized by statute was not liberal enough". Examination of the briefs discloses that the Court's attention had not been called to the ratification of administrative practice by Congress. However, that part of the Court's opinion was not necessary to its decision, it being sufficient for that purpose that both the articles and the by-laws of the taxpayer specifically *excepted* it from any liability to account to its patrons for the reserves in question on the basis of patronage so there was no basis for the deduction whatever.

Moreover, in the present case, as contrasted with the *Cooperative Oil* case, the petitioner does not rely entirely on this administrative practice, but relies also upon fundamental law which exempts it from taxation upon funds which are not income to it.

In concluding this point, it is respectfully submitted that when the Board ruled herein that members must be entitled to withdraw their funds at will else a cooperative will be taxed thereon, it set up a new standard in conflict with the decisions of the Supreme Court, in conflict with consistent administrative practice ratified and approved by Congress, in conflict with its own previous decisions and in disregard of the true nature of these funds.

II. THE FUNDS UPON WHICH THE TAX IS LEVIED ARE NOT INCOME OF THE COOPERATIVE.

We have shown in Point I that if the funds sought to be taxed constituted "borrowed" moneys, they were deduc-

tible under the tax statutes. As hereinafter appears, the relation of lender and borrower at least existed. We believe the obligation was higher, that the moneys in the "Reserve for Zoning Hazard", "Reserve for Security of Membership" and "Reserve Against Loss by Overpayment for Eggs" were held by the cooperative as agent for the benefit of the members. If so, of course, it was not taxable income of the cooperative.

Mertens Law of Federal Income Taxation, sec. 17.07 to 17.12;

Mutual Benefit Life Insurance Co. v. Herold, 198 F. 199 (affirmed 201 F. 918; *certiorari* denied 231 U. S. 755);

Uniform Printing & Supply v. Commissioner, 88 F. (2d) 75;

Board of Fire Underwriters, 26 BTA 860

Commissioner v. Berkeley Hall School, Incorporated, 84 F. (2d) 539;

AnSCO Photo Products v. Clark, 34 F. (2d) 568.

Cf.

Producers Creamery Co. v. United States, 55 F. (2d) 104;

Farmers Union Co-op. Co. v. Commissioner, 90 F. (2d) 488.

The facts are not disputed. Whether or not under them the funds constitute taxable income to the cooperative or, on the other hand, moneys borrowed by it with obligation to repay or held by it as agent for the benefit of its members, is one of law. In determining this question, it is axiomatic that the intention of the parties, i.e., the intention of the cooperative and its members—as disclosed by

the agreement between them, and their actual dealings, governs.

To arrive at the intention of the parties in the instant case we analyze below, first, the intention of the parties as disclosed by the source of the funds; second, the intention of the parties as disclosed by the contract between them; and third, the intention of the parties as disclosed by the ultimate disposition of the funds. We then point out, fourth, that the respondent does not meet the questions presented but assumes the point in issue:

1. The Intention of the Parties as Disclosed by the Source of the Funds.

The cooperative serves its members in two ways; first, it markets their poultry products, and second, it functions for them as a purchasing cooperative.

In respect to the first service, for the years in question (1936 and 1937), it marketed poultry and poultry products by collecting weekly pools of eggs of the members and giving them checks in proportion to each member's contribution at the end of each week. (R. 51, 52.) The amounts received by the members were determined by the Los Angeles market quotations, less expenses. One cent per dozen was authorized to be deducted and placed in an advance fund (by-laws, Art. VIII, sec. 3, R. 127). In respect to the second service, members purchased through the cooperative seed and other supplies. The cost to the members was based on the cost to the association, plus the cost of mixing, delivering and selling, including office (R. 53 and 54) and was fixed slightly above the actual cost plus expenses to preclude any loss. (R. 54.)

The funds held in the reserves came from these two sources, that is, from the deductions on sales and the "overcharges" on purchases. These deductions were set up in the "Reserve Against Loss by Overpayments for Eggs" (R. 68 and 136), and placed on the books to the credit of the individual producer. (R. 71.) The overcharges were also set up in the reserves here attempted to be taxed and placed on the books to the credit of the individual members in proportion to their patronage. (R. 54, 57, 62, 63, 138-146.) Not one penny of the reserves represented moneys from non-members. Some of the retains and overcharges were returned to the members. (R. 59, 137.) No attempt is made to tax the amounts returned.

This manner of dealing between the cooperative and its members—amounting to an accounting by the cooperative to its members—is indicative of an agency and trust relationship, without reference to the agreement between them, hereinafter mentioned.

2. The Intention of the Parties as Disclosed by the Contract Between Them.

The law under which the cooperative is organized, its articles of incorporation and by-laws pursuant thereto, constitute the contract between the cooperative and its members.

Jones v. Missouri-Edison Electric Company, 144 F. 765;

McGarry v. Lentz, 13 F. (2d) 51;

Fawkes v. Farmlands Inv. Corp., 112 Cal. App. 374, 297 P. 47;

18 *Corpus Juris Secundum*, 1147, sec. 477.

The cooperative was organized under the *Agricultural Non-Profit Cooperative Marketing Association Act of California*. (Agric. Code of the State of California, Secs. 1191-1221.) Under that Act, associations so organized are not "organized to make profits for themselves as such, or for their members as such but only for their members as producers". (Section 1192 *Agricultural Code, supra.*) It has no stock, only membership certificates, and it cannot make, declare, or pay to its members any dividend on these certificates. (R. 95.) Thus, its only need for income is for working capital and expenses. But what directly speaks on the intention of the parties is that the cooperative and its members have specifically agreed that the moneys held by the cooperative, after deduction of expenses, shall belong to the members.

In its by-laws, Article VIII, sec. 1 (R. 125), it is provided:

"The 'net proceeds' shall be such funds as are derived from overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the Directors."

"The 'net proceeds' resulting from the operation of the business, if any, shall belong to the members and shall be known as 'Members' Purchase Credits' and shall be prorated to them in proportion to the amount of business each member has transacted with the association during the period of time in which said 'Members' Purchase Credits' have accumulated."

In this connection, respondent states:

"It is true that the By-Laws state that the 'net proceeds' shall belong to the members, but this provision apparently refers only to the proceeds of the

‘purchasing division’ of the taxpayers’ business.”
(*Respondent’s Brief*, p. 20.)

This is not so, for the term is expressly defined to include funds left after all expenses have been paid and all “net proceeds resulting from operations of the business”. Moreover, that the proceeds from sales of eggs, including the one cent per dozen retained, were held on behalf of the members is indicated in section 3, Article VIII of the By-Laws. (R. 126, 127.)

Under this agreement, these overcharges and retains (constituting the net proceeds), when actually collected by the cooperative, do belong to the members. Indeed, such amount of it as is actually turned over to members, is recognized by the respondent as theirs, and no tax is attempted to be levied on that amount. It is all very well to characterize such recognition and deductions as “mere administrative grace” or “rebates”. There is, of course, no such thing as “administrative grace” in connection with tax liability—it is the legislature, not the administrative officers, who enacts tax laws. Calling it a rebate is merely recognizing it as the moneys of the members in the first place.

Considering this express intention of the parties in connection with the source of the funds hereinabove discussed, we submit that the evidence must be considered as uncontroverted that these “retains” and “overcharges” were held by the cooperative as agent for its members. The creating and setting up of the reserves was a recognition of this. They were set up in lieu of a present distribution with the intention that so far as unused, they would be returned to the members.

The onerous levy here attempted is a tax of the entire reserve before any return of part is made to the members and before any part has been appropriated as working capital of the cooperative. It may be conceded that when portions of the fund are actually appropriated by the cooperative for its own use as working capital, whether to build a new site or otherwise, that portion of the fund becomes the property of the cooperative, but then, and only then, does it become its property, and only then does the question of taxability arise. Even then two hurdles would have to be surmounted before any amounts appropriated to the working capital of the cooperative would be taxable. First, as pointed out in our first point, it would be deductible as an obligation of the cooperative to its members unless released by them; second, as hereinafter pointed out, even if released, it would constitute a tax-exempt voluntary prorata contribution to capital. (See p. 24, *infra*.)

3. The Intention of the Parties as Disclosed by the Ultimate Disposition of the Fund.

Analysis of their ultimate disposition demonstrates that the funds belong to the members, though held by the cooperative. Let us see what actually may happen to these funds. First, part has been returned to the members and, as pointed out, no attempt is made to tax this part.

Second, part of the funds will eventually be returned to the members. This portion is being taxed as income of the cooperative, although it never has nor will be the property of the cooperative. Third, the remainder of the fund not returned to the members, we assume, may some day be appropriated by the cooperative as working capital. *Whether or not this portion of the fund would constitute*

taxable income of this cooperative need not here be decided, as the tax is here attempted to be levied against the entire fund prior to any such appropriation. In order to complete our analysis, we point out, however, that it is extremely doubtful whether or not even such amounts as may be appropriated would be taxable income of the cooperative. If we assume that the obligation to members therefor is actually cancelled so that this hurdle of treating the moneys as taxable income is done away with, nevertheless, it would amount to nothing more or less than voluntary prorata payment by the members in augmentation of the working capital of the cooperative. Considered such, it would not constitute income under the *Federal Tax Law* but a voluntary contribution. (See *Merten's, Law of Federal Income Taxation*, Vol. 1, p. 200, sec. 5.13; *Commissioner v. Auto Strop Safety Razor Co., Inc.*, 74 F. (2d) 226; *Carroll-McCreary, Inc., v. Commissioner*, 124 F. (2d) 303.

This principle has been covered by *Regulation 94*, Article 22(a)-17:

“If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary prorata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company.”

But, however that may be, what we desire to particularly point out here is that at this time there is no such point before the Court. There has been no cancellation of the obligation to the members and no appropriation as yet by the cooperative of any of the funds sought to be taxed.

4. The Respondent Does Not Meet the Questions Presented But Assumes the Point in Issue.

Respondent has devoted two pages and three lines to the contention that the funds constitute taxable income to the cooperative. (Respondent's Brief, pp. 19-21.) On page 19, he begs the question, stating: "The net proceeds from the operations of a non-exempt cooperative marketing and purchasing association constitute income to the association". This assumption he supports by the following arguments:

An incorporated cooperative association, like any other corporation, is a distinct corporate entity, existing separate and apart from its members; neither the Agricultural Code of the State of California nor the cooperative's by-laws divest the cooperative of control of the proceeds of its operations and, lastly, the right of members to possess the proceeds is vested in the directors and only part refunded to the members. (Respondent's Brief, pp. 19-20.)

It may be conceded that the cooperative is a corporate entity. But a corporate entity can, and often does act as an agent. *The very purpose for which a cooperative in the instant case was set up, was to act as an agent for its members. Bogardus v. Santa Ana Walnut Growers Association*, 41 Cal. App. (2d) 939, 108 Pac. (2d) 52, *Mountain View Walnut Growers Association v. California Walnut Growers Association*, 19 Cal. App. (2d) 227, 65 Pac. (2d)

80; *Reinert v. Calif. Almond Growers Exchange*, 9 Cal. (2d) 181, 70 Pac. (2d) 190. The law is so clear as to be not subject to dispute and is everywhere recognized. *Texas Certified Cottonseed Assn. v. Aldrich*, 61 S. W. (2d) 79; *Rhodes v. Little Falls Dairy Company*, 245 N. Y. S. 432; *Cunningham v. Long* (Maine), 135 Atl. 198; *Johnson v. Staple Cotton Corp.* (Miss.), 107 So. 2; *Spencer Cooperative v. Schultz* (Wis.), 245 N. W. 99; *Mountain States Beet Growers v. Monroe* (Colo.), 269 Pac. 886; *Yakima Fruit Growers Association v. Henneford, et al.* (Wash.), 47 Pac. (2d) 831.

The above cases involve cooperatives and establish beyond argument that a cooperative may (for that matter, any other legal entity may), act as agent for members or any person.

The argument that the *Agricultural Code of the State of California* and the cooperative's by-laws do not divest petitioner of the proceeds of its operations again begs the question. The point is, *are* the funds held in the reserves the proceeds of the cooperative or its members? The question is one of intention to be gathered by the contract between the parties, as reflected by the governing statute, the Articles of Incorporation and By-Laws of the corporation. And, the by-laws specifically provide that these reserves belong to the members.

Respondent's argument, that the rights of members to possess the proceeds is subject to the discretion of the directors, is based on the by-laws' permitting the setting up of reserves. The establishing of reserves is not incompatible with an agency relationship.

Conceding, for the purpose of argument, that the rights of members to possess these funds is within the directors' discretion, this would only indicate that the cooperative, besides acting as agent, holds the property with power to appropriate a portion for its working capital. This is a well recognized relation between cooperatives and their members. *Bogardus v. Santa Ana Walnut Growers Association, supra*; *Mountain View Walnut Growers Association v. California Walnut Growers Association, supra*; *Reinert v. California Almond Growers Exchange, supra*; *Texas Certified Cottonseed Assn. v. Aldrich, supra*; *Rhodes v. Little Falls Dairy Company, supra*; *Cunningham v. Long, supra*; *Johnson v. Staple Cotton Corp., supra*; *Spencer Cooperative v. Schultz, supra*; *Mountain States Beet Growers v. Monroe, supra*; *Yakima Fruit Growers Association v. Henneford, supra*.

It is equally well recognized in other relationships of agency. *Morley v. University of Detroit*, 263 Mich. 126, 248 N. W. 570; 90 A. L. R. 464; *Rusco v. Ryan*, 153 Pac. 1162, 54 Okla. 641; *Coburn v. Davis*, 207 N. W. 586, 201 Iowa 1253 (agent to sell lots and account to principal after deducting commission); *Weaver Piano Co. v. Curtis*, 155 S. E. 291, 158 S. C. 117.

These fundamental concepts of law have been overlooked in the case at bar in deciding the case against the taxpayer.

Respondent cites the following cases as supporting its assertion that the reserves are taxable income of the cooperative: *Farmers' Union Co-op. Company v. Commissioner*, 90 F. (2d) 488; *Cooperative Oil Ass'n v. Commissioner*, 115 F. (2d) 666; *Fruitgrowers' Supply Co. v. Com-*

missioner, 56 F. (2d) 90; *Callaway v. Farmers' Union Co-op. Association*, 119 Nebr. 1, 226 N. W. 802.

In *Farmers' Union Co-op. Company v. Commissioner*, *supra*, the validity of our argument is recognized. The Court in that case held, however, that under the statutes and the cooperative's articles and by-laws, the money upon which a tax was levied was, in fact, the cooperative's money. The Court said:

"Its [petitioner's] relation to this money must be determined by the law under which it was organized and operates. Among the statutory powers are to 'make by-laws for the management of its affairs, and to provide therein * * * for the distribution of its earnings'."

Facts in that case showing that the funds taxed belonged to the cooperative and not the members were: the cooperative had full power to provide "*for the distribution of its earnings*" (Court's italics); distribution was required only "*in part*" (Court's italics) to be on a patronage basis; and no action had been taken by the directors to fix a liability for any part to be so distributed; and the by-laws, after providing for surplus, required, "*there shall be paid an annual dividend from the net profits of 8 per cent on the par value of all the paid capital stock*". (Court's italics.) In answering the contention that there was no profit to the corporation, the Court said:

"This argument would acquire force and would require examination here if such were the situation of petitioner. The reason why such argument is not here applicable, is that distribution of earnings was not required by the governing statutes, the articles

of incorporation, or the by-laws to be confined to patrons.”

In the case at bar, there is no capital stock, no dividends; it is expressly provided in the by-laws that the net proceeds “shall belong to the members”, and the directors had acted to acknowledge the liability and set it up on the books to the credit of the patrons.

Cooperative Oil Ass’n v. Commissioner, supra, is similarly distinguishable. It is discussed herein, pp. 16-17.

In *Fruitgrowers’ Supply Company v. Commissioner, supra*, the Court simply ruled that as the petitioner was engaged in the business of purchasing supplies and furnishing supplies to non-members, it was not doing the type of business exempted by law, and its profits thus derived were taxable and constituted income of the corporation. It was an ordinary corporation, no evidence of agency or creditor and debtor relationship was presented.

Hallaway v. Farm, Etc. Coop. Ass’n, supra, was a suit to recover a patronage dividend. It was held no dividend had been declared. It is pertinent to nothing here involved.

In conclusion on this point, we point out that the effect of the tax is to penalize what is universally recognized as sound business practice in connection with cooperatives. If the funds upon which the tax is levied had all been returned to the members, there would have been no tax. The fact that the return of it has been delayed, pending possible appropriation of part to the working capital of the cooperative, is seized upon by the Commissioner as an excuse to claim that all the funds comprising this reserve is taxable income to the cooperative.

III. THE DECISION REVERSES THE SETTLED POLICY OF THE LAW, DISCRIMINATING AGAINST, INSTEAD OF IN FAVOR OF, COOPERATIVES.

It has been the settled policy of the law to favor cooperatives, even to discriminate in their favor as against other business ventures. We respectfully refer the Court to the appendix, herein wherein is discussed the growth and extent of this policy. Under the decision of the Board of Tax Appeals in this case, this policy is reversed. We have already seen how, in effect, it refuses to cooperatives any tax benefit from the existence of their obligations with the exception of demand obligations—a situation which obtains with no other taxpayer. Likewise it denies to them the application of the usual principles of the law of agency. We propose to now show how it attacks and dries up their only source for obtaining adequate capital funds by levying a tax on those funds, a tax which the ordinary corporation completely escapes. To get the full significance of this situation, let us examine it in more detail.

There are at most only four ways for a cooperative to raise its working capital: (1) sale of capital stock; (2) membership fees; (3) borrowings, or (4) pro rata contributions.

The sale of capital stock as in the case of the ordinary business corporation is not possible with non-stock associations such as petitioner herein; it has never been adequate even with stock associations, since they are not organized for profit, and capital is not attracted where returns are limited. This method which ordinary corporations have and which is tax exempt is therefore denied the cooperative.

Membership fees have proved inadequate and of declining importance:

“As a means of securing subscriptions to capital, the membership fee is constantly declining in importance. This is for the reason that experience has shown that only nominal fees are satisfactory and that, after all, the most consistent and reliable source of revenue will arise from deductions or retains after the association is in operation.”

(Evans & Stokdyk, *Law of Cooperative Marketing*, pp. 164-165.)

The third method, borrowing, if confined to borrowing from banks or professional lenders is satisfactory only as to supplementing capital raised otherwise, but is obviously unsound and impractical as the exclusive or even the principal means of raising capital.

But borrowing from patrons in the form of deductions or retains from their accounts, revolving the funds thus borrowed at convenient periods, has proved easy, practical and within the spirit and purpose of the cooperative movement. It means that those who use the association most contribute the greatest amount. Because of the obvious advantages, it has become the common practice for associations to thus raise their principal capital funds on a revolving fund basis, much as petitioner has done herein. (See: *Bogardus v. Santa Ana Walnut Growers Assn.*, *supra.*) Evans & Stokdyk, *Law of Cooperative Marketing*, have this to say (p. 174):

“A common practice in dealing with membership contributions is to handle them in the form of revolving funds. This practice contemplates the repayment of the first contributions to capital when the desired

amount of fixed and operating capital is obtained. It assumes, of course, that new contributions to capital will be made constantly. * * * Several of the older and better established cooperatives now revolve from one fifth to a third of their capital each year. An association should not be bound, however, to revolve any portion of its capital at any given time. Exigencies might easily arise which would embarrass an association so bound."

Borrowed money does not constitute taxable income:

"Moneys received by way of a loan do not constitute taxable income. Obviously such receipts do not fall within the concept of income as that term is used in the Sixteenth Amendment, and no attempt has been made in any of the Revenue Statutes to reach and tax such receipts as income." (*Mertens, Law of Federal Income Taxation*, Vol. 1, Sec. 5.24.)

Even where the obligation for the funds borrowed is forgiven by the shareholder of a corporation, it does not create taxable income. Reg. 94, Article 22 (a)-14:

"* * * In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt."

Moreover pro rata contributions to capital from shareholders of a corporation are excluded from taxable income. Reg. 94, Article 22(a)-17, quoted *supra*, p. 24; Mertens, *Law of Federal Income Tax*, Vol. 1, Sec. 5.13.

Now whether these retains are considered as moneys held on behalf of the patrons, borrowed money or as pro rata contributions should make no difference as to taxa-

tion; they should be deductible in any of these events. To refuse to consider them in either of these classes, or, so considering them, to deny their exclusion from income is to reverse the policy of the law favoring cooperatives with a vengeance. It would confine cooperative financing almost exclusively to professional money lending agencies—an utterly inadequate source; and it would deny to members of cooperatives the rights accorded to shareholders of a profit-making business corporation, viz.: the making of a tax-free contribution to its capital.

We respectfully submit that the decision is wholly untenable. If permitted to stand, the non-profit cooperative will find itself under such a burden that its whole utility may be destroyed.

Dated, San Francisco,

January 4, 1943.

Respectfully submitted,

W. GLENN HARMON,

J. EDWARD JOHNSON,

WILLIAM H. HENDERSON,

*Attorneys for Wayne E. Mayhew and
Herman G. Brissman, Certified
Public Accountants, As Amici
Curiae.*

(Appendix Follows.)



Appendix

REVIEW OF POLICY FAVORING COOPERATIVES.

Although the beginnings of the cooperative movement go well back into the nineteenth century, its modern development is of comparatively recent origin and has received its greatest impetus from the fact that the ordinary business corporate structure has been found utterly unsuited to the economic welfare of the farmer. The trend of the existing commercial corporation is in the direction of constantly increasing size and the throwing of control into the hands of fewer and fewer men. By reason of the very nature of agriculture, such a method of handling its business has been shown wholly unsuitable, and tended to widen the breach between the producer and consumer and to permit the building of large middleman profits at the expense of both. The result has been a tremendous impetus to the nonprofit cooperative, which is at once mutual in its character and decentralized in its control. The fundamental difference between the two theories is thus pointed out by Mr. Justice Brandeis in *Lewis K. Liggett Co. v. Lee*, 288 U.S. 518:

“But Americans seeking escape from corporate domination have open to them under the Constitution another form of social and economic control—one more in keeping with our traditions and aspirations. They may prefer the way of cooperation, which leads directly to the freedom and equality of opportunity which the Fourteenth Amendment aims to secure. That way is clearly open, for the fundamental difference between capitalistic enterprise and the cooperative—between economic absolutism and industrial democracy

—is one which has been commonly accepted by legislatures and the courts as justifying discrimination in both regulation and taxation.”

It is worthy of note that Mr. Justice Brandeis also wrote the Court's opinion in *Penn Mutual Life v. Lederer*, *supra*.

The essential purpose of ordinary corporations is profit; they are resorted to as a means of exempting individuals from personal liability while at the same time affording opportunity for profits. The departure of the cooperative principle from this concept has been well expressed by Gerald B. Henderson, in 23 *Columbia Law Review*, p. 91:

“The profit incentive is the mainspring of commerce, but is the antithesis of cooperation. The cooperative principle requires its services be performed for the cooperating members by their appointed representatives and not by independent business units, dealing at arm's length and striving for profits. It implies that the cooperating members are the real parties in interest in any transaction undertaken by their association. At no time can the association as a corporate entity have any interest in the marketed product adverse to the interest of the members, for whose benefits the operations are conducted. Yet, so far as it is possible, without sacrificing this essential characteristic, the association must adapt itself to the usages of trade. The merchant who buys its product, the banker who lends it money, properly insist that there be a responsible legal entity with which dealings can be had, that the property contributed by the members be subjected to the hazards of the venture in which it has been launched, that the officers of the association have the powers normal in the conduct of trade, and that no secret and unusual restrictions

hamper their authority in ordinary business transactions. By conferring on the association legal title with the powers of disposition which are incident to legal title, the members have successfully achieved this result. *By insisting that this legal title exists for a special and limited purpose, for the benefit only of those who deal with the association in good faith and in the normal course of business, the rights of the members as the real parties of interest are preserved.*" (Italics supplied.)

Responding to the very definite need for better facilities in agriculture and in other fields lending themselves to co-operative ventures, both the state and the federal government have enacted numerous laws, authorizing and encouraging cooperatives. Those having a capital stock somewhat similar to the ordinary corporation were first in the field. By 1900 some eleven states had enacted laws permitting this type of cooperative, and since that time nearly every state in the union has followed suit. The earliest law of the non-stock type was passed in California in 1895 (*Session Laws of 1895*, Chapter 183), and similar acts have gradually extended from that date to other states. The movement has, of course, not been without opposition. The greatest hurdle to overcome was the charge that such organizations constituted restraints on trade. It is generally recognized today, however, that they are legitimate because they are beneficial to the public at large. (Evans & Stokdyk, *Law of Cooperative Marketing*, pp. 5 to 18.)

The Federal Government itself has legislated to foster and encourage cooperatives. In 1914 the *Clayton Act* was

passed containing a clause exempting from the act non-stock cooperative associations (38 Stat. 731, 15 U. S. C., Sec. 17); in 1922 this exemption was enlarged to include both stock and non-stock cooperatives (42 Stat. 388, 7 U. S. C., Sec. 291); also in 1922 the *Capper-Volstead Act* expressly authorized cooperative associations. (42 Stat. 388, 7 U. S. C. Sec. 451.) Aid of an affirmative nature has also been provided. The *Federal Cooperative Marketing Act* (44 Stat. 802, 7 U. S. C. Sec. 451) was passed to bring about the development upon a broad and unified basis of a marketing system for agricultural products. In 1923 the *Intermediate Credit Bank Act* (39 Stat. 360, 12 U. S. C. Sec. 641), provided additional credit facilities for cooperatives. In 1933, the *Farm Credit Act* set up twelve regional banks for cooperatives, one in each of the twelve federal land bank districts. (42 Stat. 1454.) In *Liberty Warehouse Co. v. Burley Tobacco Growers Coop*, 276 U. S. 71, 92-93, in commenting on the fact that up until 1928, forty-two states had enacted cooperative statutes, the Supreme Court said:

“Congress has recognized the utility of cooperative associations among the farmers in the *Clayton Act*; the *Capper-Volstead Act*, and the *Cooperative Marketing Act of 1926*. These statutes reveal widespread legislative approval of the plan for protecting of scattered producers and advancing the public interest.”

The Court gave the reason for this attitude as follows:

“The opinion generally accepted—and upon reasonable grounds, we think—is that cooperative marketing statutes promote the common interest. The provisions for protecting the fundamental contracts against inter-

ference by outsiders are essential to the plan. This court has recognized, as permissible, some discrimination intended to encourage agriculture * * * and in many cases it has affirmed the general power of the state so to legislate as to meet a definitely certain evil.”

The revenue acts have themselves from the beginning of the modern income tax contained exemptions designed to favor cooperatives which the Treasury Department until now has construed liberally, with Congress approving that policy. (see Brief, *supra*, pp. 11-17.)



No. 10272

United States 16
Circuit Court of Appeals
For the Ninth Circuit.

SAN FERNANDO MISSION LAND COM-
PANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

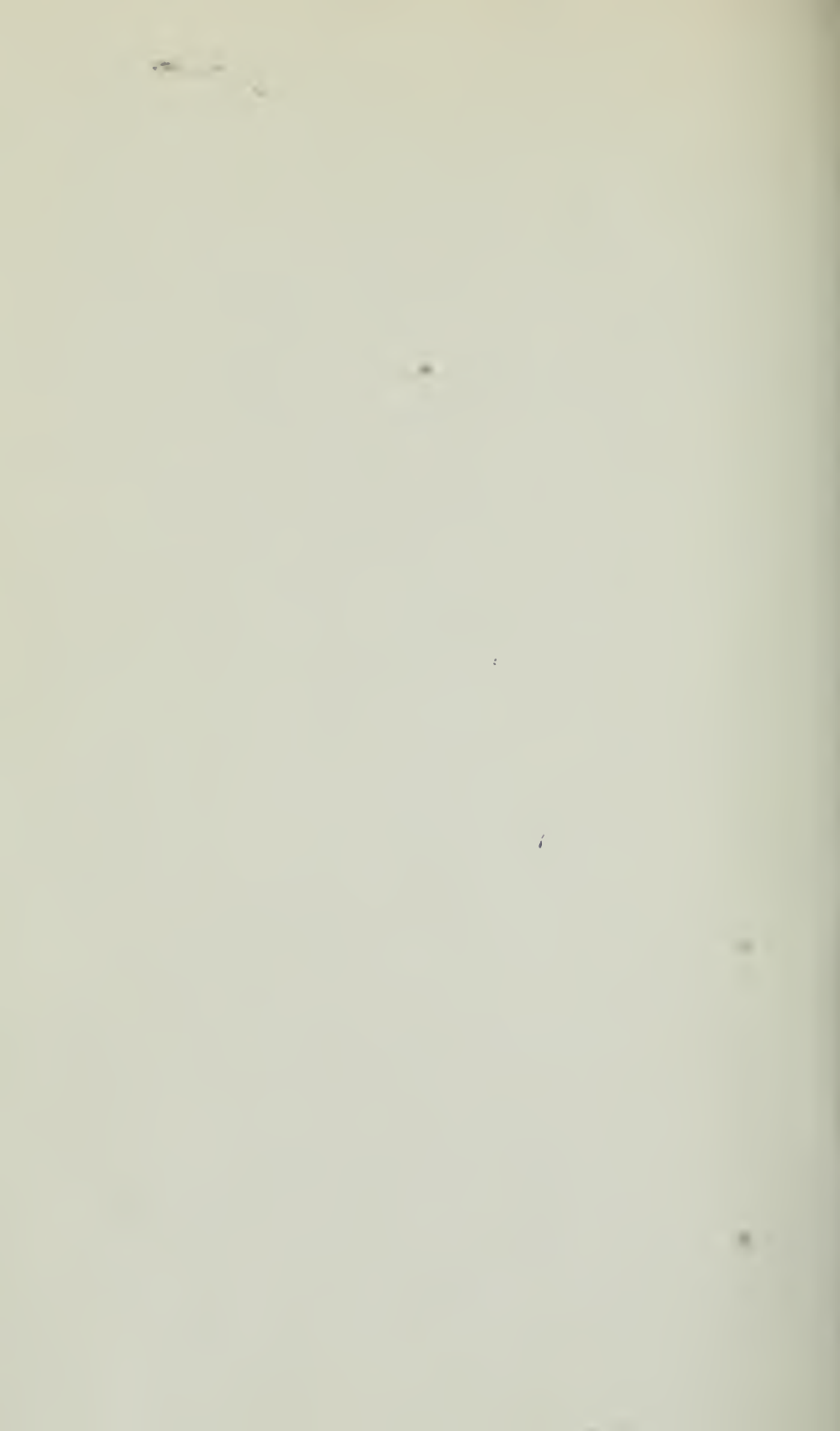
Transcript of the Record

Upon Petition to Review a Decision of the United
States Board of Tax Appeals

FILED

NOV - 3 1942

PAUL P. O'BRIEN,
CLERK



No. 10272

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For the Ninth Circuit.

SAN FERNANDO MISSION LAND COM-
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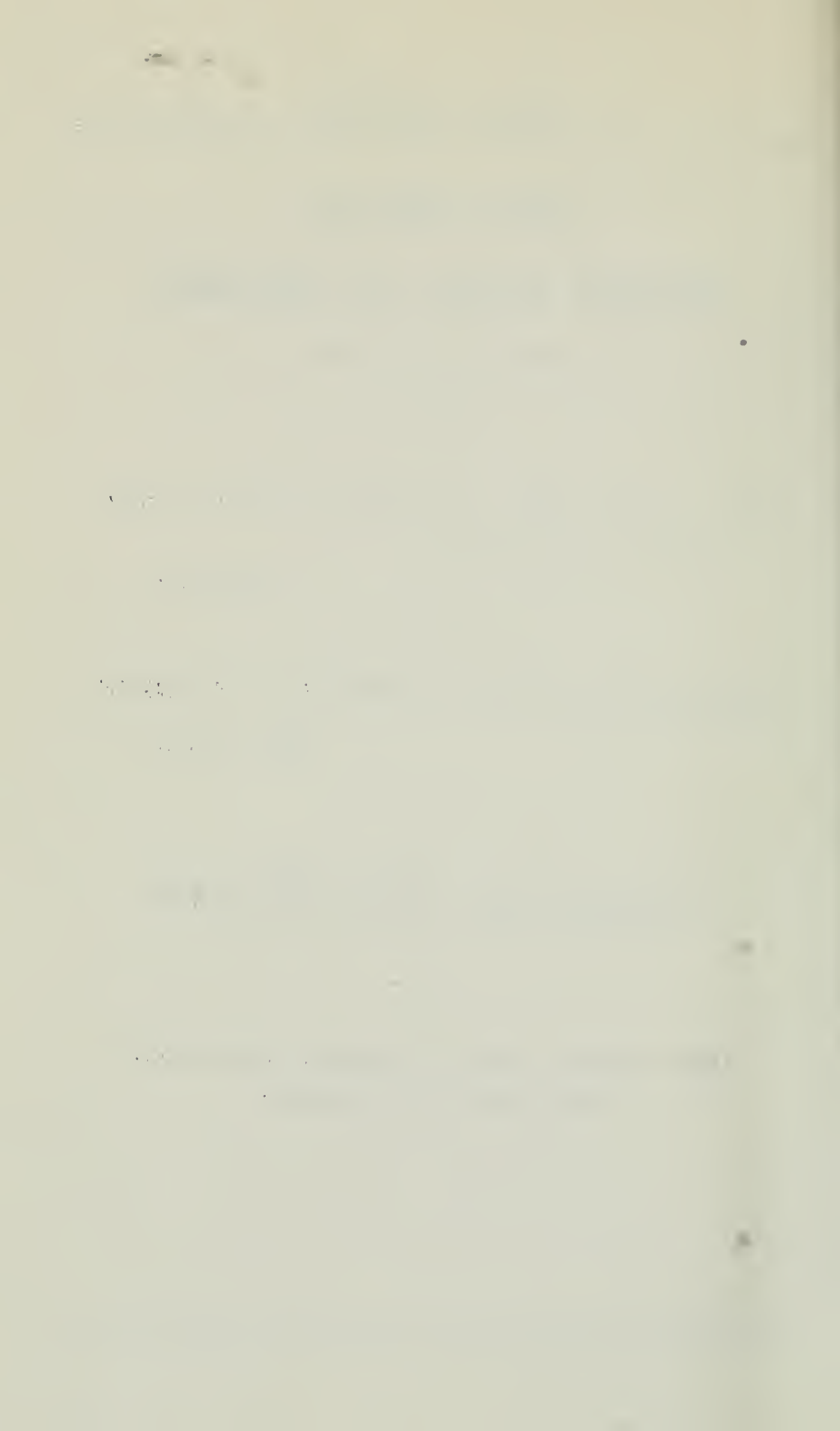
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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Docket No. 107149

SAN FERNANDO MISSION LAND CO.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPEARANCES

For Taxpayer :

GEORGE R. OLINCY, C.P.A.

ERNEST ALLEN TOLIN, Esq.,

HARRY GRAHAM BALTER, Esq.,

For Comm'r. :

SAMUEL TAYLOR, Esq.

DOCKET ENTRIES

1941

May 5—Petition received and filed. Taxpayer notified. Fee paid.

“ 5—Copy of petition served on General Counsel.

“ 11—Answer filed by General Counsel.

“ 11—Request for hearing in Los Angeles, Calif., filed by General Counsel.

“ 14—Notice issued placing proceeding on Los Angeles calendar.

Service of answer and request made.

1941

Dec. 24—Hearing set Feb. 2, 1942 at Los Angeles, Calif.

1942

Feb. 6-9—Hearing had before Mr. Sternhagen on merits. Submitted. Appearance of Ernest A. Tolin, filed. Briefs due under the Rule.

Mar. 9—Transcript of hearing of Feb. 6, 1942 filed.

“ 9—Transcript of hearing of Feb. 9, 1942 filed.

“ 23—Brief filed by taxpayer.

“ 26—Brief filed by General Counsel.

“ 27—Copy of brief served on General Counsel.

Apr. 6—Reply brief filed by taxpayer. 4/6/42 copy served.

May 6—Motion to cite the *Magruder v. Washington, Baltimore and Annapolis Realty Corporation* case filed by General Counsel.

“ 7—Motion granted.

May 25—Memorandum findings of fact and opinion rendered, Sternhagen, Div. 10. Decision will be entered for the respondent. 5/26/42 copy served.

“ 25—Decision entered, Sternhagen, Div. 10.

Jun. 18—Motion for review of opinion and review by entire Board with petition for revision filed by taxpayer.

“ 19—Order denying revision entered.

“ 19—Order that motion for revision and review of the Memorandum Findings of Fact and Opinion of Div. 10 is denied and the motion in so far as it asks for review by the Board is denied, entered.

1942

Jul. 24—Notice to recognize Harry Graham Balter in the appeal to the 9th Circuit filed by taxpayer.

“ 24—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

“ 24—Proof of service filed.

“ 24—Affidavit of service by mail of petition for review, substitution of counsel and notice of filing petition for review filed by taxpayer.

“ 25—Proof of service of notice of filing petition for review filed.

Aug. 31—Certified copy of order from the 9th Circuit enlarging the time to Oct. 3, 1942 for the filing of the transcript of record filed
[1*]

Sept. 9—Praecipe for record filed by taxpayer.

“ 9—Affidavit of service by mail filed by taxpayer.

“ 14—Certified copy of an order from the 9th Circuit requesting Board to transmit all of petitioner's exhibits 1 to 54 and all of respondent's exhibits A to M inclusive to this Court filed.

“ 15—Agreed statement of evidence filed. [2]

*Page numbering appearing at top of page of original certified Transcript of Record.

United States Board of Tax Appeals

Docket No. 107149

SAN FERNANDO MISSION LAND CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION

The above named petitioner hereby petitions for the redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols LA:IT:90D:EIS), dated February 8, 1941, and as a basis of this proceeding alleges as follows:

1. The petitioner is a California corporation with its principal office at 1031 South Broadway, Los Angeles, California. The return for the period here involved was filed with the Collector of Internal Revenue for the Sixth Collection District of the State of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on February 8, 1941.

3. The taxes in controversy are income and excess-profits taxes for the calendar year 1938, and in the amount of \$12,544.20, of which amount \$12,246.64 is in controversy. [3]

4. The determination of taxes set forth in the said notice of deficiency is based upon the following errors:

(a) The determination that petitioner was subject to excess-profits tax for the calendar year 1938.

(b) The disallowance of Commissions Paid, in the sum of \$33,306.88, as a deduction from income from the calendar year 1938.

(c) The disallowance of Attorney's Fees, in the sum of \$250.00, as a deduction from income for the calendar year 1938.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner was organized during December, 1904, for the principal purpose of subdividing and selling real estate. By the year 1922, the petitioner had disposed of the greater part of its land and thereupon became inactive. No property of petitioner was sold from January 1, 1927 to November 10, 1937; no directors meetings were held between February 2, 1927 and September 14, 1936; no stockholders' meetings were held for a period even longer. During the period from July 1, 1937 to June 30, 1938, the sole activities of petitioner consisted of liquidating two property holdings, maintaining its few remaining assets pending their sale and liquidation, and maintaining its corporate existence. During the period from July 1, 1937 to June 30, 1938, petitioner was not doing business within the [4] purview of Sections 601 and 602 of

the Revenue Act of 1938. The petitioner was not subject to capital stock tax for the year ended June 30, 1938. The petitioner was not subject to excess-profits tax for the calendar year 1938.

(b) The petitioner executed an oil and gas lease with the Shell Oil Company on November 25, 1938, covering 380.65 acres in unproven oil territory. Said lease provided for the payment of a bonus upon its execution of \$200.00 per acre, said bonus totalling \$76,130.00. The bonus represented all sums payable during the term of the lease, excluding royalties on oil and gas produced. The term of the lease was for 20 years, and for so long thereafter as lessee shall conduct drilling or producing operations, however, lease shall ipso facto terminate upon lessee's failure to commence drilling of a well within two years from date of lease, and failure to thereafter continue to develop the property in accordance with the lease terms. The petitioner retained Robert V. New to negotiate said lease and, upon its execution, to pay him a commission for his services so rendered based solely on the bonus received for said lease at time of execution. The commission so paid to Robert V. New amounted to \$33,306.88, said compensation being calculated solely on the aforesaid \$76,130.00 bonus received in 1938. The commission so paid to Robert V. New was paid for personal services rendered by him in 1938, was reasonable in amount, and was commensurate with the services so rendered by him. The entire commission so paid to

Robert V. New was a properly deductible expense for the calendar year 1938. [5]

(c) Petitioner retained George Emerson, Esq., Attorney-at-Law, to render services in the preparation of the oil and gas lease heretofore referred to for which he was paid a fee of \$250.00. The fee so paid to George Emerson was paid for his services rendered in 1938, was reasonable in amount, and was commensurate with the services so rendered by him. The attorney's fee so paid to George Emerson was a property deductible expense for the calendar year 1938.

Wherefore, the petitioner prays that this Board may hear the proceeding and determine that the deficiency due from the petitioner for the year 1938 should not be in excess of \$297.56.

GEORGE R. OLINCY

Counsel for Petitioner

1913 Wilshire Boulevard

Los Angeles, California [6]

(Duly Verified.) [7]

EXHIBIT "A"

Treasury Department
Internal Revenue Service
Twelfth Floor
U. S. Post Office and Court House
Los Angeles, California

Form 1232
Office of
Internal Revenue Agent
In Charge
Los Angeles Division
LA:IT:90D:EIS

SN-IT-3

Feb. 8, 1941.

San Fernando Mission Land Co.
Room 305
1031 South Broadway
Los Angeles, California

Sirs:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1938 discloses a deficiency of \$4,508.56 and that the determination of your excess-profits tax liability for the year mentioned discloses a deficiency of \$8,035.64 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Los Angeles, Calif., for the attention of L. A.: Conf. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,

Commissioner,

By (Signed) GEORGE D. MARTIN

Internal Revenue Agent
in Charge

Enclosures:

Statement

Form of waiver.

EIS/hfk [8]

STATEMENT

LA:IT:90D:EIS

San Fernando Mission Land Company
 Room 305,
 1031 South Broadway
 Los Angeles, California

TAX LIABILITY FOR THE TAXABLE YEAR ENDED
 DECEMBER 31, 1938

	Liability	Assessed	Deficiency
Income Tax	\$ 9,723.12	\$ 5,214.56	\$ 4,508.56
Excess-Profits Tax	8,035.64	None	8,035.64
Total.....	\$17,758.76	\$ 5,214.56	\$12,544.20

In making this determination of your income tax and excess-profits tax liability, careful consideration has been given to the report of examination dated July 16, 1940; to your protest dated August 12, 1940; and to the statements made at the conferences held on August 26, 1940 and December 5, 1940.

It is held that under sections 601 and 602 of the Revenue Act of 1938 you are subject to the excess-profits tax for the taxable year 1938. Accordingly, your contention that the corporation is exempt from the excess-profits tax is denied.

A copy of this letter and statement has been mailed to your representatives, Messrs. W. H. Ingold and G. R. Olincy, c/o Ingold and Olincy, 1913 Wilshire Boulevard, Los Angeles, California, in accordance with the authority contained in the power

of attorney executed by you and on file with the Bureau.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return.....		\$31,603.36
Unallowable deductions and additional income:		
(a) Commissions	\$33,306.88	
(b) Attorney fees	250.00	
(c) Rental income	1,803.40	35,360.28
	<hr/>	<hr/>
Net income adjusted.....		\$66,963.64
		[9]

Explanation of Adjustments

(a) and (b). The deduction of \$33,306.88 as an ordinary and necessary business expense, representing the commission paid for the securing of an oil and gas lease, and the deduction of \$250.00, representing the payment of an attorney fee for the drawing of said lease, are held to be capital expenditures returnable through depletion and not allowable as deductions under the provisions of section 23(a) of the Revenue Act of 1938.

(c) Represents lease rentals collected in advance in 1938 without restriction as to its use, disposition or enjoyment.

COMPUTATION OF TAX

Excess-Profits Tax	
Taxable net income.....	\$66,963.64
No value of capital stock declared in your capital stock tax return for the year ended June 30, 1938.	
Net income subject to excess-profits tax.....	\$66,963.64
Excess-profits tax:	
12% of \$66,963.64.....	\$ 8,035.64
Excess-profits tax assessed:	
Original, account No. 400734.....	None
	<hr/>
Deficiency of excess-profits tax.....	\$ 8,035.64
Income Tax	
Taxable net income.....	\$66,963.64
Less:	
Excess-profits tax	8,035.64
	<hr/>
Adjusted net income.....	\$58,928.00
Tax at 19% of \$58,928.00.....	\$11,196.32
Less:	
2½% of dividends-paid credit.....	1,473.20
	<hr/>
Total income tax	\$ 9,723.12
Income tax assessed:	
Original 1939 list, account No. 400734.....	5,214.56
	<hr/>
Deficiency of income tax.....	\$ 4,508.56

[Endorsed]: U.S.B.T.A. Filed May 5, 1941. [10]

[Title of Board and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the

above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits that the taxes in controversy are income and excess-profits taxes for the calendar year 1938; denies the remainder of the allegations contained in paragraph 3 of the petition.

4. (a) to (c), inclusive. Denies the allegations of error contained in subparagraphs (a) to (c), inclusive, of paragraph 4 of the petition.

5. (a) to (c), inclusive. Denies the allegations of fact contained in subparagraphs (a) to (c), inclusive, of paragraph 5 of the petition. [11]

6. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore it is prayed that the determination of the Commissioner be approved.

[Signed] J. P. WENCHEL,
 FTH
 Chief Counsel,
 Bureau of Internal Revenue.

Of Counsel:

ALVA C. BAIRD,
 Division Counsel.
FRANK T. HORNER,
SAMUEL TAYLOR,
 Special Attorneys,
 Bureau of Internal Revenue.

ST/fat 6/5/41

[Endorsed]: USBTA Filed Jun 11, 1941. [12]

[Title of Board and Cause.]

MEMORANDUM FINDINGS OF FACT AND OPINION

The Commissioner determined deficiencies for 1938 of \$4,508.56 in income tax and \$8,035.64 in excess profits tax. Petitioner assails (1) the determination that it was subject to excess profits tax, contending that it was not carrying on or doing business; (2) the disallowance of a deduction for commission paid for negotiating an oil lease for petitioner as lessor; and (3) the disallowance of the deduction of an attorney's fee for drawing the lease.

FINDINGS OF FACT

1. Petitioner is a California corporation with principal office at Los Angeles, California, and filed its 1938 income tax return with the Collector there. It was organized in 1904 to buy, develop and sell land; it acquired over 16,000 acres about fifteen miles from the center of Los Angeles, and engaged actively and successfully in the development and sale of this tract. In 1918 it declared a dividend of \$1,000,000 which it paid by a distribution of lands among its shareholders. Thereafter it donated some land to the city for parks, restricted its business activity, reduced its capitalization from \$1,000,000 to \$100,000, and distributed \$1,250,000 in a series of dividends, the last being one of \$100,000 paid on January 29, 1923. Few assets remained, and share-

holders displayed little interest in the corporation, but it was not dissolved. After a meeting on February 2, 1927, the directors did not again meet for nearly a decade. On state franchise tax returns, petitioner was described as "practically liquidated."

Petitioner's remaining properties after 1930 consisted of a thirty-five acre grove of orange and lemon trees, 138 acres of unplotted hill lands, reservations of mineral rights in some 3,000 acres of land previously sold, and a very small amount of cash. The grove was in poor condition, unprofitably operated for many years, and in 1937 the trees were uprooted and it was abandoned to the state for unpaid taxes. The hill lands lying some twenty miles from the center of Los Angeles were without improvements or available water. Of the original acreage, they constituted a part for which no buyer was found. The grove and these lands were carried on petitioner's books at \$52,500 and \$13,800, respectively. The reservations of mineral rights were carried at \$1.00. In selling its real estate, petitioner had in some cases reserved mineral rights and as in early years had authorized its officers to execute oil and gas leases. The board of directors in 1925 gave consideration to proposals for oil leases, and at the meeting on February 2, 1927, they considered several proposals and ratified a release of the reserved rights in certain land for a consideration of \$2,940. At the same time they resolved to make no more such releases "for the present, at least."

After 1930, petitioner operated the grove at a continual loss; in 1932 it made one sale of realty for about \$1,500; in 1935 it rented pasture for \$75, and in 1936 it received \$7,500 for release of oil reservations and for a lot. Taxes [13] and expenses exceeded income except in 1936, and the balance sheet constantly showed a deficit of about \$40,000 during the period. In 1936 no oil had been found on or near petitioner's properties and no survey for oil had been made. At the instigation of the president of one of petitioner's creditors, the directors met on September 14, 1936, and elected him president. He entered into negotiations for the leasing of oil rights. A lease, authorized by the directors and placed in escrow on November 10, 1937, was not delivered because of the lessee's failure to perform conditions. On his initiative, the grove was abandoned in the fall of 1937.

During the fiscal year July 1, 1937—June 30, 1938, petitioner received \$51.87 in the sale of fruit; \$50 from the rental of pasture; and two other small items. From the sale of 4.75 acres of the hill lands it realized a profit of \$1,890 and in the sale of reserved oil rights it received \$1,180. Its total income was \$3,270.66, and its expenses and taxes were \$2,897.34. On March 16, 1938, petitioner made a twenty-year lease of oil rights for royalties which are being paid. On August 26, 1938, it made a lease of oil rights for \$20,000 and royalties from oil as long as produced.

Petitioner received income from its leases in 1938, 1939 and 1940, and declared dividends in each of those years.

In the fiscal year ending June 30, 1938, petitioner was carrying on and doing business.

2. On August 26, 1938, petitioner employed Robert V. New to promote and negotiate oil leases. His compensation was to be based on the amount of rental. Through New's efforts, petitioner made a lease of oil rights on November 25, 1938, for a minimum period of twenty years, receiving \$76,130 and the right to a royalty. Pursuant to the employment agreement, petitioner paid New \$33,306.88 for negotiating this lease and paid an attorney \$250 for preparing the instrument.

OPINION

Sternhagen: 1. The petitioner's claim that in the capital stock tax year ending June 30, 1938, it was not carrying on or doing business rests upon the view that its activities of that period were incidental to a long-existing intention to liquidate and were so slight as to be negligible and hence should, for present purposes, be disregarded. As to the intention to liquidate, whatever may have been said as to its significance under earlier decisions must now be revised in view of *Magruder v. Washington, Baltimore & Annapolis Realty Corporation*,U.S.....(April 13, 1942); for that decision held a corporation which was expressly formed for liquidation to be subject to the capital stock

tax. In the "nebulous field of confusion" affecting this subject, Article 43 (a)(5) of Regulations 64 was held to be controlling, and in that article liquidation was not per se enough to support exemption.

The evidence shows that the petitioner was not dormant, as it contends. During the taxable year, it owned an orange grove from which it derived some income and upon which it paid expenses. The fact that the grove was abandoned during the tax year can not overcome the fact that while the activities lasted in the tax year they were business activities. It owned 133.25 acres of unplotted lands which remained of the 16,000 acres which it originally purchased, and in the tax year it sold 4.75 acres at a profit of \$1,890. It held reserved oil rights on 3,000 acres the surface of which it had previously sold, and in the tax year it sold the oil rights on one piece of land at a profit of \$1,180. It made oil leases on two pieces of property. It rented pasture land. All these activities were relatively unimportant in comparison with those of earlier years, but they can not be disregarded. [14] Considered by themselves, they are evidence of carrying on business by the corporation as best it could under the circumstances existing at the time. That it was ready to do whatever business came its way and make whatever current profit was available is shown by the evidence of substantial transactions later in 1938 involving oil leases for long terms. This activity was not a departure from earlier

plans and practices; similar attempts were made in the tax year. At the meeting of September 14, 1936, it considered leasing its oil rights and thereafter actively sought to do so.

We hold that petitioner was carrying on or doing business in the year ending June 30, 1938, and that it was properly determined to be subject to excess profits tax for the calendar year 1938. Cf. *United States v. Trust No. B.I. 35*, 107 Fed. (2d) 22; *Allen v. Rogan*, 39 Fed. Supp. 424.

2. The Commissioner held that the \$33,306.88 commission paid to New out of the bonus upon the execution of the twenty-year oil lease was not deductible as an ordinary and necessary expense in carrying on trade or business. We think the determination must be sustained. The payment was an inherent cost to petitioner, as lessor, of a contract expected to yield royalty income for a period of years, and was not an ordinary expense of operation. *Bonwit Teller & Co.*, 17 B.T.A. 1019, affirmed on this point, 53 Fed. (2d) 381.

3. For the same reason, the deduction of the attorney's fee of \$250 for drawing the lease was correctly disallowed.

Decision will be entered for the respondent.

Entered: May 25, 1942.

[Seal] [15]

United States Board of Tax Appeals
Washington

Docket No. 107149

SAN FERNANDO MISSION LAND COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

In accordance with the Board's Memorandum Findings of Fact and Opinion, entered May 25, 1942, it is

Ordered and Decided that there are deficiencies for 1938 of \$4,508.56 in income tax and \$8,035.64 in excess profits tax.

Enter:

Entered May 25, 1942.

[Seal] (s) J. M. STERNHAGEN,
Member. [16]

[Title of Board and Cause.]

PETITION FOR REVISION AND
REVIEW

To the Honorable Chairman of the United States
Board of Tax Appeals and the Members
Thereof:

HISTORY OF PROCEEDINGS

Your petitioner, through its attorneys named below, respectfully represent:

1. That in accordance with the law and procedure therein provided, your petitioner duly filed a petition with the Board, said petition bearing the docket number above given, against deficiency proposed by the respondent, and issue was had thereon.

2. That among the issues in the pleadings aforesaid, were the following:

a. Whether or not the petitioner was "carrying on or doing business" at any time during [17] the period from July 1, 1937 to June 30, 1938.

b. Whether or not the commission paid to Robert V. New in the sum of \$33,306.88 for services in negotiating the lease with the Shell Oil Company is a properly deductible expense in the year 1938.

c. Whether or not the attorney's fee paid to George H. Emerson in the sum of \$250.00 for assisting in preparing the lease with the

Shell Oil Company is a properly deductible expense in the year 1938.

PETITION FOR REVISION

Your petitioner respectfully prays that the Board will revise and amend the findings of fact of its division in the following particulars:

1. That the petitioner was not "carrying on or doing business" in the fiscal year ending June 30, 1938.
2. That the commission paid to Robert V. New is a deductible expense in the year 1938.
3. That the attorney's fee paid to George H. Emerson is a deductible expense in the year 1938. [18]

PETITION FOR REVIEW

Your petitioner, believing that the opinion rendered by the division of the Board in these proceedings is at variance with the facts and with the law therein provided, requests that the entire opinion be reviewed, and if found proper, reversed.

In order to facilitate and clarify this petition, the opinion rendered by your division is reviewed herewith but your petitioner nevertheless requests and feels that it is entitled to have the arguments presented in its Brief and Reply Brief, heretofore filed with the Board, studied in connection with this petition.

ISSUE OF WHETHER OR NOT THE PETITIONER WAS "CARRYING ON OR DOING BUSINESS" AT ANY TIME DURING THE PERIOD FROM JULY 1, 1937 TO JUNE 30, 1938

Errors of Fact

The facts supporting this issue are not in controversy, and the introduced oral testimony and documentary evidence fully reflect them for your review. In making the Finding of Fact that the petitioner was "carrying on and doing business in the fiscal year ending June 30, 1938", your division disregarded and gave no consideration to the following material evidence:

1. That the petitioner had entirely discontinued the business for which it was incorporated. (R. 80)
[19]

2. That the activities of the petitioner during said fiscal year were incidental to a long-existing intention of the petitioner to liquidate. (Petitioner's Exhibits No. 39 to 49, both inclusive, R. 56 and 104-106)

3. That the petitioner was dormant over a period of many years prior to June 30, 1938, its activities during said period being so slight and incidental as to be disregarded in determining this issue. (R. 58, 81, 105, 106)

4. That the oil leasing activities and income to petitioner subsequent to June 30, 1938 arose out of events occurring after July 1, 1938, and were un-

foreseen by the petitioner or its officers on or prior to June 30, 1938. (R. 124 and 126)

Errors of Law

In rendering its opinion in this cause, your division based its decision on the following interpretation of the United States Supreme Court decision in *Magruder v. Washington, Baltimore & Annapolis Realty Corporation U.S.* (April 13, 1942), namely:

That the Supreme Court has held Article 43(a)(5) of Regulations 64 to be valid and that the term "liquidation" used therein means liquidations of every kind. Accordingly, liquidation per se is deemed to be "carrying on or doing business".

The petitioner herein could be held to be not "doing business" only if it were completely dormant, and any activity whatsoever, no matter [20] how slight or for what purpose, would be sufficient to classify it as "doing business".

It is respectfully submitted, that the interpretation so placed by your division was erroneous in law and, accordingly, should be reviewed and reversed.

The *Magruder* case, by holding that Article 43(a)(5) of Regulations 64 was valid, inferentially approved the validity of the remainder of Article 43 which is also interpretative of the term

of the statute, and does not hold that the term "liquidation" means liquidations of every kind.

Article 43(a)(5) of Regulations 64 provides as follows:

"Art. 43. Illustrations.—(a) General—In general 'doing business' includes any activities of a corporation whether it engages in——

* * * * *

"(5) the orderly liquidation of property by negotiating sales from time to time as opportunity and judgment dictate and distributing the proceeds as liquidation is effected—for example, the liquidation of an estate, or of properties taken over from another corporation, or of the shareholders' fractional interests in particular property;"

The above quoted Article 43(a)(5) is not applicable to the facts in the instant case since the petitioner's remaining assets were not received from an estate, taken over from another corporation, or of shareholders' fractional interests in particular property. The meaning of the above Article, as interpreted by the Magruder decision, covers orderly liquidation which is the very purpose for which the corporation is organized. In the instant case, the petitioner was organized to buy, develop and sell [21] land, it abandoned its purposes many years ago, and after years of absolute inactivity then undertook to liquidate its few remaining assets.

It is respectfully submitted that the facts in the within cause come squarely under Article 43(b)(1) of Regulations 64, wherein the Commissioner defines activities of a corporation not considered as "doing business". In view of the validity of this Article and in view of its applicability to the within facts, it affords the natural yardstick to measure the case at bar, rather than Subsection (a)(5).

Article 43(b)(1), Treasury Regulations 64.

"(b) Exceptions—Ordinarily the exceptions to 'doing business' are restricted to limited activities of a corporation. For example——

(1) A corporation is not subject to the tax although incorporated for the purpose of doing business, if it has retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, the distribution of its avails, and doing only such acts as are necessary to the maintenance of its corporate existence and the private management of its internal affairs."

The Magruder case does not change the effect of prior decisions but, on the contrary, reaffirms the principle that an important element in determining the issue of "doing business" is whether the corporation is carrying on the purposes for which it was organized. In the Magruder case, the Court differentiates the facts from those of Von Baum-

bach, Collector v. Sargent Land Co., 242 U. S. 503, and does not reverse that decision. In the Von Baumbach case (*supra*), at page 516, the [22] Supreme Court laid down the test to be applied in deciding the question of "doing business" as follows:

"It is evident, from what this court has said in dealing with the former cases, that the decision in each instance must depend upon the particular facts before the court. The fair test to be derived from a consideration of all of them is between a corporation which has reduced its activities to the owning and holding of property and the distribution of its avails and doing only the acts necessary to continue that status, and one which is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain and such activities as are essential to those purposes."

In the cause at issue herein, we find that the petitioner conforms to the above general test in that it still held but a small fraction of its original holdings, and that its sole activities for some 15 years prior to July 1, 1937 and during the fiscal year ending June 30, 1938 were holding and maintaining its properties while attempting their sale, and maintaining its corporate existence.

Again, the Supreme Court in *Edwards v. Chile Copper Co.* 270 U. S. 452, stated as follows:

"The exemption 'when not engaged in business' ordinarily would seem pretty nearly

equivalent to when not pursuing the ends for which the corporation was organized, in the cases where the end is profit."

The above definition exactly fits the facts in the cause at issue herein.

In view of the above, reference is made to the cases cited in Petitioner's Brief which are on all fours with the instant cause and which, as the above discussion illustrates, are not in conflict with or affected by the Magruder decision: [23]

Union Land & Timber Co. v. United States 65 Ct. Cl. 129, cited on pages 18-22 in Petitioner's Brief.

Estate of Isaac G. Johnson v. United States 37 F. Supp. 617, cited on pages 22-23 of Petitioner's Brief.

The Magruder case was decided by the Supreme Court after Petitioner's Brief and Reply Brief were drawn so that the foregoing comment is the first opportunity petitioner has had concerning this citation.

The fact that the Board of Tax Appeals has not heretofore passed on the questions herein presented suggests that this case is of sufficient importance as a precedent that it should be a decision by the full Board. The issue of "carrying on or doing business" for capital stock tax purposes normally is tried in the District Courts and the petitioner has been unable to find any expression on this subject in any of the reports of decisions of your Board.

ISSUES OF WHETHER OR NOT COMMISSION AND ATTORNEY'S FEE PAID ARE DEDUCTIBLE EXPENSES

Errors of Fact

The facts supporting this issue are not in controversy, and the introduced oral testimony and documentary evidence fully reflect them for your review. In making the Finding of Fact, your division failed to find or consider the following:

1. The division apparently misunderstood the situation as to the lease. The \$76,130.00 bonus paid in 1938 bought the following for lessee: [24]

A right to possess under the lease for two years, and if a certain thing be done during that time, viz, commence drilling a well, then, upon actual continuous operations and payment of royalty, if and when oil be produced, to continue in possession for a full term of 20 years. Thus it is apparent that lessee enjoyed a certain tenure for two years only, with an option, exercisable by continuous drilling of wells over the entire period, to enjoy a longer term. (Petitioner's Exhibit No. 29)

2. That the land so leased was unproven oil territory and that no oil has been discovered thereon to date. (R. 138)

Errors by Law

In rendering its opinion in this cause, your division held that the commission and attorney's fee paid were costs to petitioner in acquiring a contract

expected to yield royalty income for a period of years. It is respectfully submitted that, since the land was unproven oil territory, petitioner had no assurance of royalty income in the future and in view of the contingencies and speculation inherent in finding oil on the leased property, the decision on these issues should properly be that they are deductible from the only known income to petitioner under the lease, namely, the lease bonus of \$76,130.00 received in 1938.

Applying the theory of your division decision to the [25] facts to this case, we find that the petitioner would be required to report as 1938 income the sum of \$76,130.00 and is entitled to percentage depletion of $27\frac{1}{2}\%$ of such income, or \$20,935.75. It has incurred expenses for commission and attorney fee in the sum of \$33,556.88 which would not be deductible. Therefore, if oil is not found the petitioner would be required to reflect the depletion as income and would be entitled to deduct the expenses in the year of cancellation of said lease. Since the expenses exceed the depletion by approximately \$13,000.00, the effect of the treatment of this transaction in the manner suggested by your division, would be that income of \$13,000.00 more than the actual total profit earned would be required to be reported for income tax purposes. It is respectfully submitted that this legal theory violates the whole principle of the income tax law of properly taxing income through a distorted and unnatural treatment of this transaction.

Your Board has not previously passed upon this legal principle relating to commissions and attorney's fees paid on oil leases, to the petitioner's knowledge, but has passed on principles similar in theory, and has consistently ruled that possible but not certain events in the future are to be disregarded:

Estate of George B. Leonard Holding Corporation
26 B.T.A. 46
Crossett Timber & Development Company, Inc. 29
B.T.A. 705 [26]

Your petitioner asserts that, in its judgment, this case cannot properly be disposed of without giving further consideration to the questions herein presented. For these, and other reasons as are more fully disclosed in your petitioner's Brief and Reply Brief heretofore, it respectfully urges that the findings of your division be revised and that the conclusion reached thereon be reviewed by the entire Board.

Respectfully submitted,

GEORGE R. OLINCY

1913 Wilshire Boulevard
Los Angeles, California
Counsel for Petitioner.

Of Counsel:

ERNEST A. TOLIN

Los Angeles, California.

[Endorsed]: USBTA Filed Jun. 18, 1942. [27]

[Title of Board and Cause.]

ORDER DENYING "REVISION"

Having considered the petitioner's Motion and Petition for Revision filed June 18, 1942, and finding that they contain nothing which has not been heretofore fully considered and disposed of in the Memorandum Findings of Fact and Opinion entered May 25, 1942, the motion and petition are Denied.

[Seal] (Signed) J. M. STERNHAGEN,
Member.

Dated June 19, 1942. [28]

[Title of Board and Cause.]

ORDER

The petitioner on June 18, 1942, filed a motion for revision and review of the Memorandum Findings of Fact and Opinion of Division No. 10 (Sternhagen). The motion in so far as it asks for revision has been denied by Division No. 10. The motion in so far as it asks for review by the Board is hereby denied.

[Seal] (Signed) J. E. MURDOCK,
Chairman.

Dated—Washington, D. C., June 19, 1942. [29]

[Title of Board and Cause.]

PETITION FOR REVIEW BY THE UNITED
STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

To the Honorable, the Judges of the United States
Circuit Court of Appeals for the Ninth Circuit:

I
JURISDICTION

San Fernando Mission Land Company, your petitioner, respectfully petitions this Honorable Court to review the decision of the United States Board of Tax Appeals, entered on the 25th day of May, 1942, and finding a deficiency in excess profits taxes due from the petitioner for the calendar year 1938, in the amount of \$8,035.64.

Your petitioner is a corporation organized under the laws of the State of California, having its principal office and place of business at Los Angeles, California.

The return of excess profits taxes for the period herein involved, was filed with the Commissioner of Internal Revenue for the Sixth Collection District, in the City of Los Angeles, [30] State of California, which is located within the jurisdiction of the Circuit Court of Appeals for the Ninth Judicial Circuit.

Jurisdiction in this court to review the decision of the United States Board of Tax Appeals aforesaid, is founded on Internal Revenue Code Section 1141, (a) and (b) (1).

II

NATURE OF CONTROVERSY

The petitioner, on the 2nd day of May, 1941, filed with the United States Board of Tax Appeals, its petition requesting a re-examination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols LA:IT:90D:EIS), dated February 8, 1941, in the amount of \$4,508.56 in income taxes, and \$8,035.64 in excess profits taxes, for the calendar year 1938.

The issues to be determined by the United States Board of Tax Appeals were set out in said petition and in the answer of the Commissioner filed thereto. This case was heard before the Honorable John M. Sternhagen, at Los Angeles, California, on February 6th, 1942.

On May 25th, 1942, the United States Board of Tax Appeals entered a "Memorandum Findings of Fact and Opinion" which contained findings of fact as follows: [31]

III

FINDINGS OF FACT

The Board of Tax Appeals made the following Findings of Fact:

"1. Petitioner is a California corporation with principal office at Los Angeles, California, and filed its 1938 income tax return with the Collector there. It was organized in 1904 to buy, develop and sell land; it acquired over

16,000 acres about fifteen miles from the center of Los Angeles, and engaged actively and successfully in the development and sale of this tract. In 1918 it declared a dividend of \$1,000,000 which it paid by a distribution of lands among its shareholders. Thereafter it donated some land to the city for parks, restricted its business activity, reduced its capitalization from \$1,000,000 to \$100,000, and distributed \$1,250,000 in a series of dividends, the last being one of \$100,000 paid on January 29, 1923. Few assets remained, and shareholders displayed little interest in the corporation, but it was not dissolved. After a meeting on February 2, 1927, the directors did not again meet for nearly a decade. On state franchise tax returns, petitioner was described as 'practically liquidated.'

"Petitioner's remaining properties after 1930 consisted of a thirty-five acre grove of orange and lemon trees, 138 acres of unplotted hill lands, reservations of mineral rights in some 3,000 acres of land previously sold, and a very small amount of cash. The grove was in poor condition, unprofitably operated for many years, and in 1937 the trees were uprooted and it was abandoned to the state for unpaid taxes. The hill lands lying some twenty miles from the center of Los Angeles were without improvements or available water. Of the original acreage, they constituted a part for which no buyer was found. The grove and these lands were car-

ried on petitioner's books at \$52,500 and \$13,800, respectively. The reservations of mineral rights were carried at \$1.00. In selling its real estate, petitioner had in some cases reserved mineral rights and as in early years had authorized its officers to execute oil and gas leases. The board of directors in 1925 gave consideration to proposals for oil leases, and at the meeting on February 2, 1927, they considered several proposals and ratified a release of the reserved rights in certain land for a consideration of \$2,940. At the same time they resolved to make no more such releases 'for the present at least.' [32]

"After 1930, petitioner operated the grove at a continual loss; in 1932 it made one sale of realty for about \$1,500; in 1935 it rented pasture for \$75, and in 1936 it received \$7,500 for release of oil reservations and for a lot. Taxes and expenses exceeded income except in 1936, and the balance sheet constantly showed a deficit of about \$40,000 during the period. In 1936 no oil had been found on or near petitioner's properties and no survey for oil had been made. At the instigation of the president of one of petitioner's creditors, the directors met on September 14, 1936, and elected him president. He entered into negotiations for the leasing of oil rights. A lease, authorized by the directors and placed in escrow on November 10, 1937, was not delivered because of the lessee's fail-

ure to perform conditions. On his initiative, the grove was abandoned in the fall of 1937.

“During the fiscal year July 1, 1937—June 30, 1938, petitioner received \$51.87 in the sale of fruit; \$50 from the rental of pasture; and two other small items. From the sale of 4.75 acres of the hill lands it realized a profit of \$1,890 and in the sale of reserved oil rights it received \$1,180. Its total income was \$3,270.66, and its expenses and taxes were \$2,897.34. On March 16, 1938, petitioner made a twenty-year lease of oil rights for royalties which are being paid. On August 26, 1938, it made a lease of oil rights for \$20,000 and royalties from oil as long as produced.

“Petitioner received income from its leases in 1938, 1939 and 1940, and declared dividends in each of those years.

“In the fiscal year ending June 30, 1938, petitioner was carrying on and doing business.

“2. On August 26, 1938, petitioner employed Robert V. New to promote and negotiate oil leases. His compensation was to be based on the amount of rental. Through New's efforts, petitioner made a lease of oil rights on November 25, 1938, for a minimum period of twenty years, receiving \$76,130 and the right to a royalty. Pursuant to the employment agreement, petitioner paid New \$33,306.88 for negotiating this lease and paid an attorney \$250 for preparing the instrument.” [33]

IV

OPINION

Based on these Findings of Fact, the Board of Tax Appeals rendered the following opinion:

“1. The petitioner’s claim that in the capital stock tax year ending June 30, 1938, it was not carrying on or doing business rests upon the view that its activities of that period were incidental to a long-existing intention to liquidate and were so slight as to be negligible and hence should, for present purposes, be disregarded. As to the intention to liquidate, whatever may have been said as to its significance under earlier decisions must now be revised in view of *Magruder v. Washington, Baltimore & Annapolis Realty Corporation*, U. S. (April 13, 1942); for that decision held a corporation which was expressly formed for liquidation to be subject to the capital stock tax. In the ‘nebulous field of confusion’ affecting this subject, Article 43 (a) (5) of Regulations 64 was held to be controlling, and in that article liquidation was not per se enough to support exemption.

“The evidence shows that the petitioner was not dormant, as it contends. During the taxable year, it owned an orange grove from which it derived some income and upon which it paid expenses. The fact that the grove was abandoned during the tax year cannot overcome the fact that while the activities lasted in the

tax year they were business activities. It owned 133.25 acres of unplotted land which remained of the 16,000 acres which it originally purchased, and in the tax year it sold 4.75 acres at a profit of \$1,890. It held reserved oil rights on 3,000 acres the surface of which it had previously sold, and in the tax year it sold the oil rights on one piece of land at a profit of \$1,180. It made oil leases on two pieces of property. It rented pasture land. All these activities were relatively unimportant in comparison with those of earlier years, but they cannot be disregarded. Considered by themselves, they are evidence of carrying on business by the corporation as best it could under the circumstances existing at the time. That it was ready to do whatever business came its way and make whatever current profit was available is shown by the evidence of substantial transactions later in 1938 involving oil leases for long terms. This activity was not a departure from earlier plans and practices; similar attempts were made in the tax year. At the meeting of September 14, 1936, it considered leasing its oil rights and thereafter actively sought to do so. [34]

“We hold that petitioner was carrying on or doing business in the year ending June 30, 1938, and that it was properly determined to be subject to excess profits tax for the calendar year 1938. Cf. *United States v. Trust No. B. I. 35*,

107 Fed. (2d) 22; *Allen v. Rogan*, 39 Fed. Supp. 424. . . .”

(Balance of Opinion relates to issues not covered in this Petition for Review.)

V

LIMITATION OF ISSUES ON APPEAL

Attention is directed to the fact that in its petition for re-examination of deficiency filed with the Board of Tax Appeals, petitioner charged the Commissioner with three errors in determination of taxes, namely:

1. The determination that petitioner was subject to excess profits taxes for the calendar year 1938;

2. The disallowance of commissions paid, in the sum of \$33,306.88, as a deduction from income for the calendar year 1938; and

3. The disallowance of attorney's fees, in the sum of \$250.00, as a deduction from income for the calendar year 1938.

The Board of Tax Appeals, in its Memorandum Findings of Fact and Opinion, and its Decision, both dated May 25th, 1942, ruled against petitioner on all three issues.

Without in any way admitting that its position as to points 2 and 3 has been incorrect, petitioner nevertheless [35] is abandoning these two points, as far as this appeal is concerned, for the practical reason that the Board's Opinion so treats the claimed expenses that the deduction is not com-

pletely disallowed but merely deferred to a subsequent year. No oil has been found on the petitioner's property under lease and the leases will, in all probability, be cancelled in the near future. As a result, the deduction for the expenses under Issues 2 and 3 will then be allowable under the Board's decision.

VI

DESIGNATION OF COURT OF REVIEW

The said San Fernando Mission Land Company, being aggrieved by the Findings of Fact contained in the "Memorandum Findings of Fact and Opinion" of the Board of Tax Appeals, and by its Decision entered pursuant thereto, desires to obtain a review thereof by the United States Circuit Court of Appeals for the Ninth Circuit, petitioner being a corporation duly organized and existing under and by virtue of the laws of the State of California, with its principal office and place of business in the City of Los Angeles, State of California, and having filed its excess profits return for the calendar year 1938 with the Collector of Internal Revenue, at Los Angeles, California. [36]

VII

ASSIGNMENTS OF ERROR

The petitioner assigns as error, the following acts and omissions of the Board of Tax Appeals:

1. The determination that petitioner was sub-

ject to excess profits taxes for the calendar year 1938.

2. The failure to find that in the capital stock tax year ending June 30, 1938, petitioner was not "carrying on or doing business" within the meaning of the applicable statutes and regulations, and decisions interpreting said statutes and regulations.

3. The failure to find that the petitioner's activities during the period of July 1, 1937, to June 30, 1938, inclusive, was not the carrying on and doing business for profit but rather for liquidation.

4. The misapplication by the Board to the facts in the case at bar of the decision of the Supreme Court of the United States in *Magruder v. Washington, Baltimore and Annapolis Realty Corporation*, decided April 13, 1942, reported in 86 L. Ed. Advance Opinions 858.

5. The failure of the Board to apply to the petitioner the benefits of the exemptions provided for in Article 43 (b) of Regulation 64 (1938 Edition).

HARRY GRAHAM BALTER,

639 South Spring St., Los Angeles, California, Attorney
for Petitioner. [37]

(Duly Verified.)

[Endorsed]: U. S. B. T. A. Filed Jul. 24, 1942. [38]

[Title of Board and Cause.]

NOTICE OF FILING PETITION
FOR REVIEW

To the Chief Counsel of the Bureau of Internal
Revenue, Washington, D. C.

Please Take Notice that the petitioner, on the
..... day of July, 1942, filed with the Clerk
of the United States Board of Tax Appeals, at
Washington, D. C., its Petition for Review by the
United States Circuit Court of Appeals for the
Ninth Circuit, of the decision of the Board hereto-
fore rendered in the above entitled cause.

A copy of the Petition for Review and the As-
signments of Error, as filed, is hereto attached and
served upon you.

Dated at Los Angeles, California, this 20th day
of July, 1942.

HARRY GRAHAM BALTER,
639 South Spring Street, Los
Angeles, California, Coun-
sel for Petitioner.

[Endorsed]: U.S.B.T.A. Filed Jul. 24, 1942. [39]

[Title of Board and Cause.]

SUBSTITUTION OF COUNSEL

Petitioner hereby substitutes and appoints Harry Graham Balter, as counsel of record herein for petitioner, in the place and stead of the former counsel of record herein.

Dated this 11th day of July, 1942.

[Seal] SAN FERNANDO MISSION
 LAND COMPANY,
 By W. H. INGOLD,
 President, Petitioner.

The undersigned, the present counsel of record for petitioner, do hereby consent to the foregoing substitution.

Dated this 11th day of July, 1942.

GEORGE R. OLINCY,
ERNEST A. TOLIN.

I hereby accept the foregoing substitution.

Dated this 11th day of July, 1942.

HARRY GRAHAM BALTER.

[Endorsed]: U.S.B.T.A. Filed Jul. 24, 1942. [40]

United States Circuit Court of Appeals
for the Ninth Circuit

No.

SAN FERNANDO MISSION LAND COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STATEMENT OF EVIDENCE

Following is a Statement of Evidence submitted to the Board of Tax Appeals in the above mentioned case, so far as is necessary to the assignment of errors as filed, reduced to narrative form:

Be It Remembered that the above mentioned cause came on regularly for trial before the Honorable John M. Sternhagen, a member of the United States Board of Tax Appeals, at Los Angeles, California, on February 6th, 1942. George R. Olincy, Esq. and Ernest A. Tolin, Esq., appeared for the taxpayer, and Samuel Taylor, Esq., Special Attorney, and J. P. Wenchel, Chief Counsel of the Bureau of Internal Revenue, appeared on behalf of the Commissioner of Internal Revenue, Respondent.

PETITIONER'S CASE

Mr. Olincy proceeded to make a statement of the [41] case on behalf of the petitioner, in substance as follows:

The year involved in this matter is the calendar year 1938. The taxes in controversy are excess profits taxes in the amount of \$8,035.64, all of which is in controversy, and income taxes in the amount of \$4,508.56, of which all but \$275.56 is in controversy.

There are three issues involved in this case. The first issue is whether or not petitioner is liable for excess profits taxes for the calendar year 1938. A decision of this issue rests upon a determination of whether the petitioner was carrying on or doing business at any time during the period from July 1, 1937 to June 30, 1938.

Under the Revenue Act of 1938, if a corporation was not doing business during the year ended June 30, 1938, it was not liable for 1938 Capital Stock Tax, and under the law, if it was not liable for Capital Stock Tax for the year ended June 30, 1938, it would not be liable for excess profits taxes in this particular case for the calendar year 1938.

Petitioner contends that it was not carrying on or doing business at any time between July 1, 1937, and June 30, 1938, and in support of this position it will prove the following:

First, that petitioner was organized in December, 1904, for the purpose, as stated in the Articles of Incorporation, of buying and selling land and water and subdividing land for sale. The organizers of the petitioner were men [42] of importance who had many outside interests and who, as far as this petitioner was concerned, were simply passive in-

vestors. Among the incorporators were Henry E. Huntington, E. H. Harriman, General Harrison Gray Otis of the Los Angeles Times, J. F. Sartori of the Security Bank of Los Angeles, and the other men in the corporation were men well known in this community. The management and control of the company from its inception until 1925 was in the hands of Mr. L. C. Brand, the founder of the Title Guarantee & Trust Company of Los Angeles. He passed away in 1925.

The petitioner was organized to acquire some 16,000 acres of land in San Fernando Valley some fifteen miles from the center of Los Angeles. By 1921 it had sold approximately 13,000 of the 16,000 acres, had distributed some 3,000 acres to its stockholders and had remaining less than 200 acres of land.

In 1919, a committee was appointed by the Board of Directors to inquire into a plan of distribution of the remaining assets of the company. In 1921 the corporation formally reduced its stated capital from \$1,000,000.00 to \$100,000.00. The petitioner was a very successful firm.

I might state in drawing the picture of the company's activities, that from 1925 to June 30, 1937, the beginning date in issue here, the corporation was dormant, inactive, and there was no one with enough interest in the company, after the passing of Mr. Brand, to prosecute the few re- [43] maining properties for sale and liquidation of the company. The only reason that the corporation did

not formally dissolve was simply the fact that there was so little property that it would have been impossible to have apportioned it among the stockholders and every effort was made to sell and distribute the property in cash rather than in kind.

We intend to present the transactions therefor from 1931 to June 30, 1937, to show a condition of dormancy and inactivity.

For the period that we are concerned with, the company did nothing that it didn't do in previous years, that is still pursued those purposes.

The second issue is whether or not commissions paid to obtain an oil lease were deductible expenses in the year in which paid. The corporation authorized Robert V. New to negotiate an oil lease. The terms of the oil lease that was executed were that a bonus of \$76,130.00 was paid and that was the only obligation on the part of the lessee to make any payment under the lease. The only other interest would be, of course, royalties if and when oil was produced. The terms of the agreement with Mr. New were that he was to get 50% of all the consideration over \$25.00 an acre. Mr. New received a check for \$33,306.88.

The issue is whether this particular item was a deductible expense. It was based upon the receipt of money, and in order to clearly reflect the income, it is the position of the taxpayer that the sum paid in commissions should be taken as a deduction of the year in which the bonus was received by the company and reported in income.

This was a salesman's commission for the lease, not a lawyer's commission, and we contend that the sum was reasonable in amount and commensurate with the services rendered.

The Commissioner disallowed this item as an expense and held that it had to be capitalized.

The third and last issue is whether attorney fees of \$250.00 incurred in drafting this lease that is referred to, is an ordinary and necessary expense, and the same point and same position of the taxpayer is taken that in order to truly reflect income for the year, that it should be deducted from the sum of money received under the lease.

Mr. Samuel Taylor, on behalf of Respondent, then made a statement of the case as follows:

There are but two issues here. One is a doing business issue. The only thing that I can add is that the corporation filed a Capital Stock Tax return showing no value for its capital stock for the capital stock tax year ending June 30, 1938. That is how the issue arises.

The other issue involves the question of whether certain amounts expended in connection with prior operations should be expenses, as petitioner contends, or should be capitalized, as the Commissioner contends. [45]

The 90-day letter from the Commissioner to the taxpayer, states as follows:

"The deduction of \$33,306.88 as an ordinary and necessary business expense representing the com-

mission paid for the securing of an oil and gas lease, and the deduction of \$250.00 representing the payment of an attorney fee for the drawing of said lease, are held to be capital expenditures returnable through depletion and are not allowable as deductions under the provisions of Section 23 (a) of the 1938 Act."

WALTER R. HILKER

was thereupon called as a witness on behalf of petitioner, and being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Ernest A. Tolin:

I am Assistant Secretary and Director of San Fernando Mission Land Company. I keep their books and look after their records. I first became connected with the company in 1925, at which time I took charge of the records and books, etc. I first became Assistant Secretary and Director about 1936. I have had the company's books and records in my custody since October of 1925.

The book you hand me is the first minute book of the San Fernando Mission Land Company. On pages 131 and 132 are recorded the minutes of the meeting of the stockholders held [46] September 14, 1936, and on pages 134 and 135 are recorded the minutes of the meeting of the directors of the com-

(Testimony of Walter R. Hilker.)

pany held immediately after the stockholders meeting on September 14, 1936.

(Copies of the said minutes of the stockholders' meeting and the directors' meeting referred to, were offered and received in evidence, and marked Petitioner's Exhibits No. 1 and No. 2, respectively, and made a part of this record.)

I obtained possession of the minute book at the time I became connected with the company, and I have had this book in my possession ever since and I have kept the minutes in it.

The San Fernando Mission Land Company was incorporated in December, 1904.

The document you show me is a Certificate of the Secretary of State of the State of California, bearing date the 3rd day of December, 1904, appended to a photostatic copy of the Articles of Incorporation of the San Fernando Mission Land Company.

(A photostatic copy of the said Articles of Incorporation of the San Fernando Mission Land Company, was offered and received in evidence, and marked Petitioner's Exhibit No. 3 and made a part of this record.)

The document you show me is a photostatic copy of a Certificate of Diminution of the capital stock of the San Fernando Mission Land Company. [47]

(A photostatic copy of the said Certificate of Diminution was offered and received in evidence and marked Petitioner's Exhibit No. 4 and made a part of this record.)

(Testimony of Walter R. Hilker.)

The document you show me is a typewritten copy certified by me as Assistant Secretary of San Fernando Mission Land Company, being a correct copy of the minutes of the Board of Directors' meeting of the company held on January 18, 1905.

(A certified copy of said minutes was offered and received in evidence and marked Petitioner's Exhibit No. 5 and made a part of this record.)

The document you show me is a certified copy of the minutes of a special meeting of the Board of Directors of the San Fernando Mission Land Company, bearing date of February 2, 1927, and it is a true copy of the minutes as they appear in the minute book.

(A certified copy of said minutes was offered and received in evidence and marked Petitioner's Exhibit No. 6 and made a part of this record, it being understood, however, that the Petitioner would subsequently supply to the Board a copy of the Statement of Assets and Liabilities which appear in the original minutes.)

I have gone through the minute book and the records of the corporation and determined what dividends have been declared by the San Fernando Mission Land Company since the time of its incorporation down to and including the 29th

(Testimony of Walter R. Hilker.)

of [48] January, 1923, and I have prepared a statement of the dates that such dividends were declared and the amount of such dividends so declared.

The document you show me is a true and correct copy of that statement prepared from the minute books.

(A copy of said statement was offered and received in evidence and marked Petitioner's Exhibit No. 7 and made a part of this record.)

No other dividends have been declared by the San Fernando Mission Land Company between the date of the last dividends shown in Exhibit No. 7; that is to say, between January 29, 1923, and June 30, 1938.

The document you show me is a certified and correct copy of the minutes of a special meeting of the Board of Directors of the San Fernando Mission Land Company bearing date of September 25, 1916.

(The said certified copy of said minutes was offered and received in evidence and marked Petitioner's Exhibit No. 8.)

(There was thereupon offered and received in evidence and marked Petitioner's Exhibits No. 9 to No. 23, inclusive, and made a part of the record, certified copies of minutes covering further dividend declarations shown in the dividend sheet marked Exhibit No. 7.)

(Testimony of Walter R. Hilker.)

The document you show me is a true and certified copy of the minutes of a meeting of the Board of Directors [49] of the San Fernando Mission Land Company held on the 10th day of November, 1927.

(The said certified copy of said minutes was offered and received in evidence and marked Petitioner's Exhibit No. 24.)

The document you show me is a true and certified copy of the minutes of the meeting of the Board of Directors of the San Fernando Mission Land Company held on the 16th day of March, 1938.

(The said certified copy of said minutes was offered and received in evidence and marked Petitioner's Exhibit No. 25.)

The document you show me is a true and certified copy of the minutes of the meeting of the Board of Directors of the San Fernando Mission Land Company held August 26, 1938.

(The said certified copy of said minutes was offered and received in evidence and marked Petitioner's Exhibit No. 26.)

The document you show me is a true and certified copy of the minutes of the meeting of the Board of Directors of the San Fernando Mission Land Company held December 8th, 1938.

(The said certified copy of said minutes was offered and received in evidence and marked Petitioner's Exhibit No. 27.) [50]

(Testimony of Walter R. Hilker.)

The document you show me is an oil and gas lease, certified by me as Assistant Secretary of the San Fernando Mission Land Company to be a true and correct copy which I prepared from the original lease.

(The said certified copy of said oil and gas lease bearing date of March 16, 1939, between San Fernando Mission Land Company and A. L. Howell, was offered in evidence and marked Petitioner's Exhibit No. 28.)

The document you show me is a true and certified copy of the original oil and gas lease bearing date of November 25, 1938, between the San Fernando Mission Land Company and the Shell Oil Company.

(The said certified copy of said oil and gas lease was offered and received in evidence and marked Petitioner's Exhibit No. 29.)

The document you show me is a true and certified copy of the original oil and gas lease bearing date of the 26th day of August, 1938, between the San Fernando Mission Land Company and Tidewater Associated Oil Company.

(The said certified copy of said oil and gas lease was offered and received in evidence and marked Petitioner's Exhibit No. 30.)

The document you show me is a true copy made from the original of the records of the corporation, of an instrument which begins "This Indenture

(Testimony of Walter R. Hilker.)

Made this 23rd day of May, 1918, by and between San Fernando Mission Land Company, [51] Grantor, and The Sunshine Company, a light company, Grantee,"

(The said copy of said deed was offered and received in evidence and marked Petitioner's Exhibit No. 31.)

The San Fernando Mission Land Company acquired approximately 16,000 acres at or about the time of its incorporation, or shortly thereafter, for the purpose of resale or subdivision. In general their property was located in the northwest part of the City of Los Angeles about 15 miles from the center of town. By "the City of Los Angeles", I refer to the corporate limits of the city. The land was not actually located in any thickly inhabited part of the city. The corporation was active in the development of this land from about 1905 to 1919. Originally there were 10 stockholders, among whom were E. H. Harriman, H. E. Huntington, Harrison Gray Otis, M. H. Sherman, and several others whom I don't recall. These men were not at all active in the affairs of the corporation during the fiscal year which ended June 30, 1938. At that time several of them still had stock but none of them had any interest in the affairs of the corporation, nor were they active in the corporation. In 1923, when the last of these dividends were paid that are shown on the statement of dividends, the company had about 200 acres

(Testimony of Walter R. Hilker.)

scattered in several places. Nothing definite was done looking toward the sale of that land between 1919 down [52] to the beginning of the fiscal year that ended on June 30, 1938. By that I mean people in the Valley around the packing house, etc., knew the property was for sale and would have been sold if a purchaser could have been found for it.

The corporation kept a cash receipt and disbursement record during the time that I was in its employ and I made the entries in those records. The company also had a general journal in which I made entries. The company also had a general ledger in which I made entries. Besides the cash receipts and disbursement records, the general journal, the general ledger and the corporation minute book, there was also kept during my employ with the corporation a stock journal and a stock ledger.

(Photostatic copies of the said books and records for the calendar years 1931 to 1938, inclusive, cash receipts and disbursements, general journal, general ledger and check disbursements, were offered and received in evidence and marked Petitioner's Exhibits Nos. 32 to 35, inclusive, and made a part of this record.)

The document you show me is a statement showing the financial condition of the corporation as of December 31, 1930, which was prepared from the financial records of the corporation.

(Testimony of Walter R. Hilker.)

(The said balance sheet was offered and received in evidence and marked Petitioner's Exhibit No. 36, and made a part of this record.)

[53]

The document you show me is a statement showing the financial condition of the corporation as of June 30, 1937.

(The said balance sheet was offered and received in evidence and marked Petitioner's Exhibit No. 37, and made a part of this record.)

Referring to Exhibit No. 36, there is an item of cash in bank \$917.45; that was all the cash the corporation had on hand at that time. The Exhibit also contains a reference under the title "Land" to an orange grove which is priced on this Exhibit at \$52,500.00. I have seen this orange grove and I have been upon it, and I have seen other orange groves. Other corporations with which I am connected operate orange groves. This particular orange grove referred to is located at the end of Laurel Canyon Boulevard partly in the City of Los Angeles and partly in the City of San Fernando. When I say it is in the City of Los Angeles I mean that it is merely within the corporate limits of the city. It is in the general vicinity of an area that is rather sparsely populated and devoted principally to other agricultural or untilled lands. The grove contains approximately 35 to 40 acres. As of December 31, 1930, the

(Testimony of Walter R. Hilker.)

grove was not in very good shape. It was run down, had some scale and wasn't in very good shape at all. The oranges which were planted there were navels. This is not in a good navel district. Valencias and some lemons are produced in that area. The grove was not being operated profitably during [54] the year 1931. There were impediments to the proper tilling and care of the grove. When the grove was planted, they put an overhead sprinkling system in, and gradually as the rains would wash the soil from the top, these pipes would sometimes come out on top of the ground and you couldn't get a plow or tractor in there to cultivate the land properly. There was considerable Johnson grass in there. Johnson grass is a weed that is very hard to eradicate and very detrimental to groves. It has been our experience that you have to kill it. It won't die of itself; it spreads, rather. During the time beginning the first of 1931 down to the 30th of June, 1937, the corporation has received some returns from crops of this grove. This grove is a part of the original 16,000 acres of land of the corporation. It wasn't sold with the other land that had been sold down to 1919 because it was just the tail-end piece of the whole property. Nobody bought it. It was for sale during that period. As to why the corporation continued to maintain the grove, I can only speak from the time I was there, 1925. It was a grove that was taken over with the other assets of the corporation

(Testimony of Walter R. Hilker.)

at that time, and we just didn't know what else to do with it. We spent a minimum of money on it to keep it up until we could sell the property. It was for sale during all of that time. We did not pay taxes on that grove during the period commencing the 1st of January, 1931, and ending July 1, 1937, because we didn't have the funds to [55] pay them with. During that time the grove was gradually deteriorating. We didn't have the funds with which to keep it up and nobody took an interest in the grove. I was the only one that looked after it. As far as the financial part of it was concerned, I didn't have the funds to keep it up with. As to the pests and the Johnson grass, the scale and those things, the condition of the grove got considerably worse. The item which appears upon this statement as of December 31, 1930, as Parcel No. 2, unplatted hill land, was a parcel of about 138 acres. That was the tail-end of the property owned by the corporation. It had never been platted into city lots or anything. It is just an unplatted tract of land. I have seen it many times. There are no improvements on it; there is no water available to it and no utilities available and no streets. It is remote from any of the established residential sections. I would say that that particular piece of land is about 18 or 20 miles from the center of Los Angeles. This property was a part of the original 16,000 acres of the corporation. It wasn't sold because they never found a buyer for it. Parcel No. 3 which appears upon this statement, is

(Testimony of Walter R. Hilker.)

a parcel of land containing approximately 1.7828 acres. As near as I could figure out, most of that property surrounding it had been sold by metes and bounds, and this was a little parcel, less than 2 acres, left between these various other sales.

(A Statement of assets and liabilities, was at this time offered [56] and received in evidence, was made a part of Petitioner's Exhibit No. 6, and made a part of this record, pursuant to understanding as reflected on page 8 herein.)

Referring to Exhibit No. 36, which was the Statement of Assets, Liabilities and Capital of the San Fernando Mission Land Company as of December 31, 1930, there appears upon that statement this item, "Prepaid Expense: Deposit on Compensation Insurance Policy". This item reflects the deposit made on an insurance policy covering the orange grove labor; that is, a compensation insurance policy. There also appears under the item "Liabilities", Accounts Payable, \$2,607.00. This was an item due the Angeles Mesa Land Company for fertilizer, tractor hire, horse hire and things like that, respecting the care of the orange grove entirely. There is also an item of \$2,000.00 due to Angeles Mesa Land Company for money borrowed. I don't recall the circumstance of that transaction. It was just a loan made to the San Fernando Mission Land Company by the Angeles Mesa Land Company.

Referring to Exhibit No. 37, which is a Statement of Assets, Liabilities and Capital for the San Fer-

(Testimony of Walter R. Hilker.)

nando Mission Land Company as of July 1, 1937, and referring to the first item appearing thereon, which is Cash in Bank, \$479.65, and the second item, which is Orange and Lemon Grove. This is the same property that appears as the Orange Grove under Land Parcel No. 1 on Exhibit No. 36. The condition of this [57] property on July 1, 1937, as compared to its condition on December 31, 1930, was that it was in much worse shape. As a matter of fact, we had received notices from the Horticultural Department, State of California, that either the grove must be thoroughly fumigated and taken care of or some other disposition made of the grove. It was badly infested with scale, and Johnson grass throughout, and was in very bad condition.

Parcel No. 2, under the item Land on Exhibit No. 37, is the same property that is described as Unplotted Hill Lands in Exhibit No. 36. There was no change whatever in the condition of this property on July 1, 1937, as compared with its condition on December 31, 1930. No improvements had been made or anything done. It was just the same property. I do not recall of any sale.

Referring to Exhibit No. 37 and the item Mineral Interests in Land, "Deed Reservations of Mineral and Other Rights in Lands now Legally Described as: Lots 3 to 14, inc., etc." \$1.00. That was a reservation for oil and mineral rights on some 3,000 acres of land in the San Fernando Valley. The 3,000 acres were part of the original 16,000 acres that the cor-

(Testimony of Walter R. Hilker.)

poration had purchased shortly after it was incorporated. This item does not appear on Exhibit No. 36. The entry was made—I think it was in 1936—by just placing the nominal value of a dollar on the whole thing. I don't know why they didn't carry it prior to that time; [58] but it is the same reservation that the corporation owned in 1930.

Referring to Exhibit No. 37, under Liabilities, the item "Accrued City and County Property Taxes, Orange and Lemon Grove, years 1931 to 1936, \$4,642.09". None of these taxes were paid. Nor were any taxes paid which appear under Taxes, Unplotted Hill Lands, years 1931 to 1936, \$2,807.60. These tax items refer respectively to the same orange grove about which I have previously testified, and to the same unplotted hill lands about which I have previously testified.

Referring to the item Accounts Payable, Angeles Mesa Land Company, \$282.79. That represents miscellaneous items advanced by the Angeles Mesa Land Company in payment of labor on the orange grove, and possibly water. It was a series of small transactions.

Referring to the item Hazeltine Packing Company, \$297.47, as an account payable. That represents advances made by the packing house for hardware and miscellaneous small items used on the orange grove entirely.

Referring to Exhibit No. 36 which shows capital stock issued and outstanding as \$100,000.00. This

(Testimony of Walter R. Hilker.)

was the correct outstanding stock as of December 31, 1930, and the same item of \$100,000.00 capital stock outstanding which appears on Exhibit No. 37 as of July 1, 1937. That is the correct capitalization as of that time.

The deficit appearing on the statement, Exhibit No. [59] 36, in the sum of \$37,339.55, was the total deficit as of December 31, 1930, and the deficit as of July 1, 1937, shown as \$41,437.95, is the correct deficit, and indicates that there was a greater deficit in 1937 than in 1930.

I have prepared from the books and records of the company a comparative statement of income and expenses from January 1, 1931, to June 30, 1937. All income and expenses of the corporation during that interval as they appear upon the books, are reflected on that statement which I prepared, and all of the income and expenses of the corporation were duly entered upon the books from which I made that statement. The document which you show me is this statement which I prepared.

(The said Statement was offered and received in evidence, and marked Petitioner's Exhibit No. 38, and made a part of this record.)

Referring to this Exhibit, there appears under Income, the item Proceeds from Sale of Oranges and Lemons, the total for this six and one-half year period being \$6,833.15. That item represents the net proceeds of the sale of oranges and lemons from

(Testimony of Walter R. Hilker.)

that grove. And there appears under Income, \$1,470.50 for the sale of property for that six and one-half year period. This refers to the sale of a small triangular piece about which I testified on Friday. There were approximately 2 acres. That appears on the balance sheet of December 31, 1930, as of no value. I think this is parcel No. [60] 3 in Exhibit No. 36. That was the net amount received from the sale of that property after the title charges and commission had been taken out. This was the only piece of that property which was sold during that time. It was sold to a lady in San Fernando by the name of Wilkinson.

Referring next to an item under Income, Sale of Oil Reservations, \$3,750.00. That was the amount received from the surface owner of a parcel of about 233 acres, which is part of the land on which the oil reservations had been made. The sale was made in 1936. This land was part of the original holding of 16,000 acres, and at the time the property was sold, the oil rights had been reserved. In 1936 we conveyed the mineral rights to the owner of the fee. This was the only sale of oil reservations that occurred during this six and one-half year period. It was sold to the Tidewater Associated Oil Company.

Referring to the next item under Income which appears as Release—Oil Lease, \$10.00, in 1936. That was an amount received from the Shell Oil Company for a quitclaim deed executed by them after

(Testimony of Walter R. Hilker.)

they had abandoned a certain well that they were drilling on part of this property.

There appears also the item Rent-Pasture, \$75.00, under 1935. That is an amount we received from a party in San Fernando for pasturing horses and cattle on the so-called hill lands. Up to that time that was the only income we had had from the hill lands. [61]

The real estate taxes which appear under Expenses as \$5,127.34, were not paid.

The item which appears as of June 30, 1937, \$3,140.15, as real estate taxes, were not paid.

Referring to an item of \$1,800.00, administration expense, that appears as of the closing date of June 30, 1937. This was a charge made by the Angeles Mesa Land Company for the administration of the affairs of the San Fernando Mission Land Company for the year 1936. This does not include any charge for the other years, that is, from 1931 on.

Services were rendered by the Angeles Mesa Land Company to the corporation in the administration of its affairs during those earlier years, but no charge was made for that. Generally, this service consisted of rental of the office, use of telephones, the overseeing of the care of the orange grove and the use of its tractor. They put much fertilizer on the grove for which they never received reimbursement. And there were various other items. I never received any compensation from the San Fernando Mission Land Company. I was an employee of the

(Testimony of Walter R. Hilker.)

Angeles Mesa Land Company during that period. I took care of the San Fernando Mission Land Company's affairs insofar as I had anything to do with them on the time of the Angeles Mesa Land Company. That is reflected in the \$1,800.00 administration expense item.

There also appears an item, Interest Paid, \$1,062.67. These are the amounts paid by the San Fernando Mission Land [62] Company to the Angeles Mesa Land Company for actual loans made by the Angeles Mesa Land Company to the San Fernando Mission Land Company.

The item, Franchise Tax, \$212.08, is the total paid to the State of California for the franchise tax for the particular years, that is, in each one of these years, from 1931 to and including 1937, we paid \$212.08, which is the minimum tax for all, except the year 1937.

The Angeles Mesa Land Company was a ten percent stockholder in the San Fernando Mission Land Company. It made loans from time to time to the San Fernando Mission Land Company. Mostly these loans went into the expenses of the care of the orange grove. The San Fernando Mission Land Company was not able to operate during this period from 1931 to June 1937, upon its own funds. During the years 1931 to June 30 of 1937, the affairs of the San Fernando Mission Land Company were managed by Mr. W. P. Jeffries, who was president and manager of the company from December 1 of 1931

(Testimony of Walter R. Hilker.)

until he passed away in June of 1935. Then Mr. R. F. Ingold was elected president in 1936, after which time he has been the president-manager of it. Mr. Jeffries became president in October of 1925, as I recall it. He continued to be president until his death which was on June 12, 1935. I was in personal contact with Mr. Jeffries during all that time. His office and my office were in the same suite. I took directions from Mr. Jeffries as to the things I did [63] concerning the San Fernando Mission Land Company, and the same has been true as to Mr. Ingold during the time that he has been president. There were no meetings of shareholders that were held, or minutes of directors that are not shown on these minute books that have been brought into court here.

Referring to the minute book in question, the date of the last meeting of directors of the corporation prior to the year 1936, was held on February 2, 1927. The last meeting of shareholders prior to the year 1936, was held on May 28, 1918. After that meeting of February 2, 1927, the directors next held a meeting on September 14, 1936. There were no meetings of any executive committee of the directors in that interval between the 2nd of February, 1927, and the time in 1936 when the board proper next met. After their meeting in 1918, the shareholders next met on September 14, 1936. There were no activities at all between the stockholders of the corporation and the corporation during that inter-

(Testimony of Walter R. Hilker.)

val, that is to say, the interval between the holding of the meeting of the directors in 1927 and the time at which a meeting was held in 1936. There was very little interest shown by any of the stockholders in the affairs of the corporation between those dates. However, several of them did write in for information which was answered by correspondence. I took care of the correspondence between stockholders, or those writing on their behalf, and the corporation, during that time. [64]

The letter which you show me, upon the letter-head of the Security-First National Bank of Los Angeles, addressed to W. R. Hilker, San Fernando Mission Land Company, is one which I as an employee of the San Fernando Mission Land Company received from the Security-First National Bank, and the carbon copy of a letter to that bank bearing date of March 16, 1933, is the carbon copy of the letter which I dictated as an answer to the letter from the Security-First National Bank.

(The said letter was offered and received in evidence, marked Petitioner's Exhibit No. 39, and made a part of this record.)

The letter which you show me, upon the letter-head of the Security-First National Bank of Los Angeles, bearing date of February 9, 1934, addressed to the San Fernando Mission Land Company, is one which I as an employee of the San Fernando Mission Land Company received from the Security-

(Testimony of Walter R. Hilker.)

First National Bank, and the carbon copy of a letter to that bank bearing date of February 16, 1934, which is the carbon copy of the letter which I dictated in answer to the letter from the Security-First National Bank, and mailed.

(The said letter was offered and received in evidence, marked Petitioner's Exhibit No. 40, and made a part of this record.)

(A series of similar letters, one or two in each year, and two in the particular year in question, were then offered and received in evidence and marked Petitioner's Ex- [65] hibits Nos. 41 to 46, inclusive, and made a part of this record.)

The document you show me is a Report on General Corporate Franchises for the year 1926, of the San Fernando Mission Land Company, which I made out in my own handwriting. It is a true copy of the original report that was filed with the State of California.

(The said report was offered and received in evidence, marked Petitioner's Exhibit No. 47, and made a part of this record.)

The document you show me is a Report on General Corporate Franchises, State of California, for the year 1927, the handwritten portions of this Report having been made out by me. It is a true copy of the original filed with the State of California.

(Testimony of Walter R. Hilker.)

(The said report was offered and received in evidence, marked Petitioner's Exhibit No. 48, and made a part of this record.)

The document you show me is a Report on General Corporate Franchises for the year 1928, which is a typewritten copy with the exception of the signatures. I prepared this report. It is a true copy of the original on file with the State of California, and I identify the signature of Mr. Jeffries as his signature.

(The said Report was offered and received in evidence, marked Petitioner's Exhibit No. 49, and made a part of this record.) [66]

The document which you show me is a statement which I prepared of Income and Expenses of the San Fernando Mission Land Company for the period of July 1, 1937, to June 30, 1938. I prepared this statement from the financial records and other records of the corporation. It reflects all of the transactions of the corporation for the period that is stated thereon.

(The said Statement was offered and received in evidence, marked Petitioner's Exhibit No. 50, and made a part of this record.)

Referring to Exhibit No. 50, being the Statement of Income and Expenses for the year of July 1, 1937, to June 30, 1938, of the San Fernando Mission Land Company, in which there appears several

(Testimony of Walter R. Hilker.)

items under income, and more particularly, to the first item, which is Proceeds from Sale of Oranges and Lemons—Final Returns, \$51.87. This represents the final payment received from the packing house from the sale of the citrus fruit taken from the land of the San Fernando Mission Land Company. By "Final Returns", I meant for the whole course of the operation of the grove.

The next items which appear under the heading Refunds—the first one being Fruit Growers Supply Company, year 1930-'31—Final \$18.48. That item represents a refund of a deduction made by the packing house from the sales of fruit for the year 1930-'31. It is a refund of a revolving fund, you might call it. That was the last refund [67] that was received from the Fruit Growers Supply Company. It was the last transaction of that kind that the San Fernando Mission Land Company had.

There appears next under Refunds—Railroad Claims—Final, \$20.53. That is an item appearing on the statement made by the packing house to the San Fernando Mission Land Company and it represents paid claims from the railroad company for fruit spoilage in transit and so forth. That was the last payment of that kind the corporation ever received.

The next item which appears is Profit on Sale of Part of Lot 1, Tract 3660—4.75 Acres, Sales Price \$2,365.00; cost of land, \$475.00. Net, \$1,890.00.

(Testimony of Walter R. Hilker.)

That was a sale of a parcel of about a little less than five acres of land to a party by the name of Marshall, and was cut out of Lot 1, of Tract 3660. The sales price was \$2,365.00, and the cost of the land was \$475.00, making a gross profit there of \$1,890.00. The expenses appear later on in the statement. This was part of the land that was originally acquired by the corporation as being part of the 16,000 acres that I have previously testified about. It was a part of the so-called hill lands there. Up to this time this parcel was the only part of that hill land that had been sold.

The next item is Proceeds from Sale of Oil Reservations to Surface Owner—John O'Melveny, \$1,180.00. That is an amount we received for the release of approximately 11 acres of land surrounding the home of John O'Melveny, and [68] his part of the land under which we held the oil reservations appearing on the balance sheet there at the price of one dollar. That was part of the land that was represented in the original 16,000 acres. This oil reservation was released to Mr. O'Melveny during the period shown on this statement.

The next item is Rental of Pasture—Hill Lands, \$50.00. That is an item we received for the rental of the hill lands for pasturing purposes.

The last item under Income is Received from Agricultural Conservation Program, \$59.78. That

(Testimony of Walter R. Hilker.)

represents an amount received from the Government covering the non-planting of the orange grove.

This gives us a total of \$3,270.66 as income for the period commencing July 1, 1937, and ending June 30, 1938. That is a true statement of all of the income of the San Fernando Mission Land Company from all sources during that year.

The statement then shows Expenses — Orange Grove Expenses, and under Orange Grove Expenses, Real Estate Taxes, \$904.60; but these taxes were not paid. These taxes were charged to the same orange grove which is in this case and about which I previously testified.

The next item of Labor, \$420.00, represents an expenditure from time to time by the San Fernando Mission Land Company for labor in the absolute necessary care of the [69] grove. By "absolute necessary care of the grove", I mean that it was a minimum care that we could possibly give it and still retain it as a grove. Sometimes one man was employed during the week, and sometimes we had two men on it. This includes labor for any necessary purposes.

The item of \$194.95 for water, was payment of water received from the city of Los Angeles and was entirely used on the orange grove.

The item of Team and Tractor Hire, \$42.75, refers to an expenditure for trying to cultivate in between the trees.

(Testimony of Walter R. Hilker.)

The Miscellaneous item of \$3.04, refers to the orange grove expenses. That was on the packing house statement. I don't recall what that was.

The next item, Real Estate Taxes—Hill Land, \$745.11, refers to the unplotted hill lands that I previously testified concerning. Subsequently that entire item was paid. I don't know whether it was paid at this period or not. A part of it was paid at the time we made a sale of the land to Marshall.

The item, Cost of Pulling out Citrus Trees—Grove Abandoned, \$456.75, is explained as follows: It had been apparent for some time past that the grove was not self-sustaining, would never be able to take care of itself, and it was finally determined that we would pull out all of the trees. And this amount represents the actual price that we [70] paid out for the pulling of those trees. Mr. Ingold and I discussed this thing many times. We just didn't know what the dickens to do with that grove, whether to try to continue on with it or just abandon it and forget it. So during this period a number of things happened that forced Mr. Ingold and myself to pull out the trees. As I have testified before, the pests, the scale, was very bad on the grove. The Johnson grass was very bad. There had been a frost that year and it damaged much of the fruit. Another thing was that the pipelines were coming through to the surface and it was absolutely impossible to get in there with a plow or tractor or anything without cutting those pipes. And the

(Testimony of Walter R. Hilker.)

grove being in such a deplorable condition and no returns from it, we just determined to pull out all of the trees. We had notices from the Horticultural Department of the County of Los Angeles that it must be fumigated on account of the pest infestation of scale. In my opinion it was not saleable as an orange grove at that time. The trees were removed in December of 1937 and February or May of 1938. We have never paid the taxes on the grove between the year 1930 and June 30, 1938. The grove was sold to the State for delinquent taxes. We didn't do anything toward redeeming it during the fiscal year from June-July, 1937, to June 30, 1938.

The item of General Expense, \$79.14, which appears on this statement is composed of—\$75.00 which was paid [71] to survey or plot the land sold to Marshall, and \$4.14 which was paid for making some blue prints of that survey.

The item of Franchise Tax, \$25.00, is the amount paid to the State of California for the Franchise Tax for that year. That was the minimum franchise tax necessary in order to maintain the corporate status of the corporation.

The item of Capital Stock Tax, \$1.00, was a tax paid to the Government on the valuation fixed by the San Fernando Mission Land Company for that year, that is, for the year 1937.

The next item of Title Charges on Sale of Property, \$25.00, refers to the costs of the policy of

(Testimony of Walter R. Hilker.)

title insurance on the sale of the property to Marshall.

There were no other or additional items of income or expenses that the San Fernando Mission Land Company had in fact during the year from July 1, 1937, to June 30, 1938.

During the same period, from July 1, 1937, to June 30, 1938, we made a loan of \$1,500.00 to the Angeles Mesa Land Company. We did not charge any interest on the loan. We did not take a note, it was just an open account. This loan is reflected by the books which have been introduced in evidence. It was made to the same Angeles Mesa Land Company which is a stockholder of this corporation.

There was a payment of \$639.73 for delinquent taxes during that year. This payment of taxes was on Lot 1 of Tract 3660, part of which was sold to Marshall. The reason [72] we paid these delinquent taxes when we were not paying other tax delinquencies was that we found it necessary to pay these taxes in order to clear the title on the property that we agreed to sell to Marshall. We had to pay the taxes on the whole lot, although we were selling only a portion of the lot.

I think we paid a corporation income tax during that year on the income for the preceding year in the amount of \$188.65, and during that year there was some money paid to Hazeltine and Angeles Mesa Land Company in payment in full of the

(Testimony of Walter R. Hilker.)

account to that date—\$282.79 was paid to Angeles Mesa Land Company, and \$297.47 to Hazeltine Packing Company (referring to Exhibit No. 37). These monies were paid to reimburse these various companies for expenditures they made for the San Fernando Mission Land Company. These items do not appear as expenses on the statement, which is Exhibit No. 50, because they represent amounts due as of the beginning of the period covered by that statement, and the loan of \$1,500.00 doesn't appear on the statement, which is Exhibit No. 50.

I don't recall the circumstances of that loan of \$1,500.00 to Angeles Mesa Land Company. It was purely an accommodation loan, made for the accommodation of Angeles Mesa Land Company.

I have prepared a statement of assets, liabilities and capital of San Fernando Mission Land Company as of [73] June 30, 1938, and the document which you show me is that statement. I prepared it from the books of the corporation.

(The said Statement was offered and received in evidence and marked Petitioner's Exhibit No. 51, and made a part of this record.)

The item which appears on this statement, Amount Receivable (from Angeles Mesa Land Company, a stockholder)—no interest, \$1,500.00, is the same transaction about which I have just tes-

(Testimony of Walter R. Hilker.)

tified, that is, the accommodation loan to that stockholder.

The item, Land—Orange and Lemon Grove, \$52,500.00, under Assets, refers to the same orange and lemon grove about which I have testified. It is the same property although the trees had been removed during the year.

The item, Unplotted Hill Lands, \$13,325.00, is the same land that is described on the other statements of assets, liabilities and capital that have been introduced here as Exhibits Nos. 36 and 37, I think, except that the property sold to Marshall is eliminated. The difference in the value represents the deduction that is made for the land that was sold to Marshall. And the item, Mineral Interests in Land at one dollar, is the same that appears on Exhibit No. 37, the statement as of July 1, 1937, the beginning of that year.

At the end of the fiscal year ending June 30, 1938, we still owed the taxes which appear under Liabilities, [74] the Accrued City and County Taxes, Orange and Lemon Grove, \$5,546.69; and on June 30, 1938, we still owed the taxes which appear under Liabilities, the Accrued City and County Taxes for Unplotted Hill Lands, years 1931 to 1937, \$2,855.42.

The corporation did not at any time since I have been connected with it carry on the business for which it was incorporated. It did not acquire any

(Testimony of Walter R. Hilker.)

new property at any time since I have been connected with it.

I have been a director of the corporation since September of 1936. I first entered its employ in October, 1925.

The assets were not distributed and the corporation liquidated prior to the close of the fiscal year ending on June 30, 1938, because it wasn't feasible to split up the land and distribute it to the stockholders. Neither was it possible under conditions that we had to sell the property. We couldn't sell the property and distribute the cash. The property was for sale during all of that time. Conditions were much different than the circumstances of the problems involved in a land dividend than the time the corporation paid out a million dollars many years ago. It is my opinion that it would not have been feasible to have distributed the land among the shareholders, that is, the unplotted hill land and the orange grove land. [75]

Cross Examination

By Mr. Taylor:

The San Fernando Mission Land Company is still in existence. It has never been dissolved.

Petitioner's Exhibit No. 14 which you show me, is a copy of the minutes of a meeting of the Board of Directors of the San Fernando Mission Land Company held on April 17th, 1919, and the particular portion of the minutes that you call my atten-

(Testimony of Walter R. Hilker.)

tion to refers to a resolution which was moved and seconded, that certain properties be sold, "being about 800 acres, and that all oil, gas and mineral rights be reserved by this company and sold subject to these rights."

I wouldn't go so far as to say that as far back as 1919 the San Fernando Mission Land Company was aware that there might be oil under its properties and that it had valuable oil rights. They reserved the oil rights. Whether they thought it was valuable or not, I don't know. The San Fernando Mission Land Company began reserving the oil rights as far back as 1919. They did not follow that as a continuous policy from then on. In the sale to Marshall there were no oil rights reserved in that.

I have examined Petitioner's Exhibit No. 6, which are the minutes of the meeting of the Board of Directors of the San Fernando Mission Land Company held on February 2, 1927, and more particularly, the part beginning "Mr. Jeffries reported". These minutes indicate that the company decided [76] not to grant any more releases for oil rights at that time.

As of the calendar year 1938 and prior thereto, the company had reserved oil rights to some 3,000 acres of land.

I do not know why in these minutes of 1927 the company decided not to release any more oil rights.

(Testimony of Walter R. Hilker.)

Throughout the period from July 1st, 1937, to June 30, 1938, and prior thereto, the company had oil rights to some 3,000 acres of land, and except as it released some of its oil rights, as for example, the sale to the Associated Oil Company which took some 230 acres out of that, it was true that as of June 30, 1938, the company kept the oil rights as to the remainder of the 3,000 acres of land, and it has continued to have oil rights to several thousand acres of land.

Referring to Petitioner's Exhibit No. 24 in evidence, which are the minutes of the meeting of the Board of Directors held on November 10, 1937, at that meeting a lease of certain oil rights was authorized by the Board of Directors. The lease was executed but nothing was ever done under the terms of the lease.

Referring to Petitioner's Exhibit 25, which are the minutes of the meeting of the Board of Directors held on March 16, 1938. At that time a lease was presented to the directors for their approval and authority to execute it covering all the oil rights in the property of the San Fernando Mission Land Company known as the Sunshine Ranch. [77] That lease was actually executed.

(At this time the Capital Stock Tax Return of the San Fernando Mission Land Company, for the year ending June 30, 1938, was offered and received in evidence and marked Respond-

(Testimony of Walter R. Hilker.)

ent's Exhibit A, and made a part of this record.)

(At this time the Income Tax Return of the San Fernando Mission Land Company for the calendar year 1938, was offered and received in evidence as Respondent's Exhibit B, and made a part of this record.)

(At this time the Income Tax Return of the San Fernando Mission Land Company for the calendar year 1939, was offered and received in evidence as Respondent's Exhibit C, and made a part of this record.)

(At this time the Capital Stock Tax Return of the San Fernando Mission Land Company for the year ending June 30, 1939, was offered and received in evidence and marked Respondent's Exhibit D, and made a part of this record.)

(At this time the Income Tax Return of the San Fernando Mission Land Company for the calendar year 1940, was offered and received in evidence and marked Respondent's Exhibit E, and made a part of this record.)

(To the receiving in evidence of Respondent's Exhibits B, C, D, & E, hereinabove referred to, Petitioner interposed objections on the ground of the irrelevancy and immateriality of each of these exhibits on the ground that they were for years subsequent to the year 1938. In each case the objection was overruled and the exhibit received.) [78]

(Testimony of Walter R. Hilker.)

Referring to Respondent's Exhibit B, on line 13 of said exhibit, it states Other Income, \$97,464.81. The corporation received that amount during the calendar year 1938. It received this money for the execution of two oil leases.

Referring to Respondent's Exhibit C, line 9, of page 1 of that exhibit, under the heading Gross Income, it states Rents, \$10,864.07. The corporation received that money in payment of deferred drilling under these leases.

Referring to the Corporation Income Tax Return for the calendar year 1940, Respondent's Exhibit E, under the heading Gross Income, on page 1, line 9, after the word Rent, there is given the sum of \$21,376.51. The corporation received that money from the two oil companies for deferred drilling. This was all upon the same properties in 1939 and 1940 which the corporation had owned in prior years, so that in 1939 and 1940 there was no acquisition, no new acquisitions which were the subject of leases.

That income was received from some of the oil rights reserved under the 3,000 acres to which I have referred, and which the minutes indicate the company decided as far back as 1919 to reserve the oil rights pertaining to those 3,000 acres.

(At this time there was offered and received in evidence and marked Respondent's Exhibit E-1 and made a part of this record, the Capital Stock Tax Return of the San Fernando Mission

(Testimony of Walter R. Hilker.)

Land Company for the year ending June 30, 1935.) [79]

(There was offered and received in evidence and marked Respondent's Exhibit F and made a part of this record, the Capital Stock Tax Return of the San Fernando Mission Land Company for the year ending June 30, 1934.)

(There was offered and received in evidence and marked Respondent's Exhibit G and made a part of this record, over the objection of Petitioner that the same was "irrelevant and immaterial", which objection was overruled, the Capital Stock Tax Return of the San Fernando Mission Land Company for the year ending June 30, 1940.)

(There was offered and received in evidence and marked Respondent's Exhibit H and made a part of this record, a certified and correct copy of the minutes of a meeting of the Board of Directors of the San Fernando Mission Land Company held on August 14, 1925.)

(There was offered and received in evidence minutes of meetings of the Board of Directors of the San Fernando Mission Land Company held on October 2, 1939, December 27, 1939, June 7, 1940, October 21, 1940 and December 17, 1940, with the right to substitute certified copies of these minutes, marked Respondent's

(Testimony of Walter R. Hilker.)

Exhibits I, J, K, L and M, respectively, and made a part of this record.)

Referring to the minutes of the Board of Directors of the San Fernando Mission Land Company, held on June 7th, 1940 (Respondent's Exhibit K), it is correct that the directors declared a dividend of \$10.00 per share to the stockholders. This dividend was actually paid in 1940 from [80] the rentals received for delayed drilling; in other words, from its reservation of oil rights.

Referring to the corporation's 1938 income tax return. Under deductions on page 1 there is a deduction of \$5,000.00 as compensation of officers. This money was paid to the president, Mr. Ingold. That was in payment of all services from the time he became president of the company in September of 1936 to the end of 1938. He had spent considerable time and effort in negotiating these leases and other affairs of the corporation. I wouldn't say that the time and effort was spent during the entire period from 1936 right through the calendar year 1938. Of course, from the year 1936 until the lease was signed for the oil company, his services consisted of whatever was necessary to the upkeep of the orange grove and trying to find finances for payment of these various items coming up, and so forth. He and I were talking about it considerably all during that time, what to do with the company. Some of the services for which this compensation was paid were rendered during the period from

(Testimony of Walter R. Hilker.)

July 1, 1937, to June 30, 1938. I do not recall without seeing the minutes, whether during that period, July 1, 1937, to June 30, 1938, there were two meetings of the Board of Directors of the company at which the disposition of the company's oil rights was discussed. That payment to the president covered anything that he may have done for the corporation, and some of the compensation that the president [81] obtained was rendered in connection with matters that were taken up at these two meetings of the Board of Directors.

Referring to Petitioner's Exhibits 37 and 51, being statements of assets, liabilities and capital of the San Fernando Mission Land Company as of July 1, 1937, and June 30, 1938, respectively, it is correct that in each of these Exhibits the reserved oil rights are placed at a value of one dollar. This is purely a nominal value. A speculative value. There was no particular effort to assign any value. Just to get it on the balance sheet. This was merely an attempt to put something on the balance sheet that recognized the possible existence of the rights. The company didn't know that they were worth anything.

Q. The company couldn't tell just what they were worth? A. No.

When I testified that certain real estate taxes were not paid, my testimony related both to the orange grove and to the hill lands. The State took over the orange grove but we subsequently redeemed

(Testimony of Walter R. Hilker.)

the hill lands. My testimony as to unpaid taxes is in no way related to the oil rights which were reserved by the company.

Referring to the payment of the bills of the San Fernando Mission Land Company by the Angeles Mesa Land Company. The San Fernando Mission Land Company had no funds with which to pay them, and from time to time we would make [82] miscellaneous advances or loans and pay bills. It is not true that the same people owned both land companies. The Angeles Mesa Land Company was interested in the San Fernando Mission Land Company because the Angeles Mesa Land Company was a 10 percent stockholder and had the management of the affairs of the corporation.

The \$1,500.00 loan by the San Fernando Mission Land Company to the Angeles Mesa Land Company has not yet been repaid. But, the loans by the Angeles Mesa Land Company to the San Fernando Mission Land Company have been repaid.

When I testified that the only reason that the corporation was not liquidated or dissolved was that it was difficult to distribute among the stockholders the orange grove and the hill lands, it was not a fact that the corporation had oil rights of potential value that were also a factor in the non-dissolution of the company. It didn't occur to anybody at that time that there was any value to the oil rights. By "at that time", I mean during the period prior to June 30, 1938.

(Testimony of Walter R. Hilker.)

Referring to Petitioner's Exhibit 50, it is true that such oil rights were sold or released to John O'Melveny for \$1,180.00.

Redirect Examination

By Mr. Tolin:

Referring to an oil lease on the part of Sunshine Ranch which I testified was executed to one William [83] McClintock. This lease was never delivered to Mr. McClintock. It was delivered to an escrow. It came back to the San Fernando Mission Land Company. In other words, the deal was never consummated.

As far as I know, the San Fernando Mission Land Company never had a survey or study made by experts to determine whether there was a probability or likelihood of there being oil or minerals upon any of this land respecting which the mineral rights and oil rights were reserved. I don't recall that they were ever acquainted with the results of any survey that might have been made by any other person prior to the close of the fiscal year ending June 30, 1938. I don't know why the corporation reserved the oil rights. It was before my time. The corporation has never, down to the present day, received royalties on oil produced on this land. Prior to June 30, 1938, there were no releases of oil reservations or transfers of oil reservations to persons other than the persons who already owned rights to the land.

(Testimony of Walter R. Hilker.)

During the history of the company, insofar as I was connected with it, down to June 30, 1938, there were four or five quitclaims issued to the surface owners for releases of the oil reservations. There were no quitclaims of oil reservations that were issued to persons other than surface owners. During the period that commenced on the 1st of January, 1931, and ended on June 30, 1938, there were two releases of oil reservations to surface owners. One was to [84] the Tidewater Associated Oil Company, and the other was to John O'Melveny. We received \$7,500.00 for the release to the Tidewater Oil Company, and we received \$1,180.00 from John O'Melveny. That is all that occurred in that period of seven and one-half years.

Recross Examination

By Mr. Taylor:

When I said that the Sunshine deal was not consummated and that the papers were returned from the escrow—I don't know the exact details, but from what I do know about it, it was because McClintock defaulted in the terms of the lease.

REUBEN INGOLD

a witness called on behalf of the petitioner, was duly sworn and testified as follows:

Direct Examination

By Mr. Tolin:

I am President of the Los Angeles Investment Company engaged in real estate development and investments. I am President of San Fernando Mission Land Company. I first became President of that company in the latter part of 1936. I first became acquainted with its affairs in the latter part of 1935. In 1935, on Mr. Jeffries' death, I became president of the Angeles Mesa Land Company, and in investigating the affairs of that company I learned that the San [85] Fernando Mission Land Company owed the Angeles Mesa Land Company a substantial amount of money, and that the Angeles Mesa Land Company was also the owner of 10 percent of the outstanding stock of the San Fernando Mission Land Company; and in making my investigation to find out how we could collect in the Angeles Mesa Land Company the money that the San Fernando Mission Land Company owed us, I learned of its affairs. I went very thoroughly into the matter of undertaking to do something by way of collection of the money that was owed to it.

I found that there were seven directors authorized, only three of whom were alive. I interviewed those three directors consisting of Mr. Sartori, Mr. Hellman and Mr. Harry Chandler. Mr. Sartori and Mr.

(Testimony of Reuben Ingold.)

Hellman were perfectly willing for their part to pay their proportion of the obligation due the Angeles Mesa Land Company, and they said so. I suggested to both of these gentlemen that it seemed to me proper that an assessment be levied on the stock of the San Fernando Mission Land Company for the purpose of raising the money to pay its creditors, its creditor being the Angeles Mesa Land Company. Mr. Sartori was perfectly willing that the assessment be levied and so stated. But he wanted me to so levy the assessment that action against the stockholders would be restricted to forfeiture of their stock. He wanted to make an outside situation whereby he would pay his proportion of the debt but didn't want to have [86] the Articles of Incorporation amended so as to provide for assessment privileges that would go beyond the forfeiture of the stock.

Mr. Sartori was vice-president of the corporation, although he denied it. The minutes showed that he was vice-president, but he had no recollection of that.

Mr. Hellman was not an officer. He was a director only.

There was no president of the corporation at that time. The presidency had become vacant upon the death of Mr. Jeffries.

At the suggestion of Mr. Sartori and Mr. Hellman, I secured proxies from a sufficient number

(Testimony of Reuben Ingold.)

of stockholders to call a special meeting of the stockholders, at which time a board of directors was elected. I was present at the meeting. I conducted the meeting. There were several shareholders there by proxy, more than an amount sufficient to hold the meeting. And I recollect of only two or three stockholders being present other than by proxy. At that meeting there was an election of a new board, as shown by the minutes. The Board of Directors meeting following that stockholders' meeting elected me president.

I don't recollect whether I inspected the properties of the San Fernando Mission Land Company after I was elected president or before. But I did sometime in that interim inspect the properties. As far as I can remember, it was [87] within a year before the time that I was elected president.

As I recollect, there were two properties, one a piece of hill land undeveloped, and one orange grove in very bad condition. I learned there were some mineral interests acquired or held through reservation on certain properties that the corporation had sold many years before.

Upon becoming president I assumed personal charge of the affairs of the corporation. I am familiar with the affairs of the corporation and the book of minutes of the corporation from the time that I became president down to the present day.

My plans for the company during that period from, say, July 1, 1937, to June 30, 1938, was to

(Testimony of Reuben Ingold.)

liquidate the company's indebtedness and dissolve as rapidly as possible after disposal of its assets. The corporation during that period had no other activities which had any other purpose.

I do not recollect any change in the condition of the company's assets as I found them at the time I came into the company in the latter part of 1936 and on July 1, 1937. Between the time that I came into the company in 1936, and June 30, 1938, there were two transactions which constituted a change in the condition of the company's assets. One was the sale of a piece of property, a small part of the hill property. One was the disposal of the reservation to the fee owner of the property in connection with the Tidewater Associated Oil Company. [88]

With respect to the orange grove that I described as a run down orange grove which was there when I took over. We attempted to find a solution to that problem but finally determined to abandon the grove and have the trees taken off. I believe that determination was reached in the fall of 1937.

Regarding the plan about which I have testified, under which assessments were to be made upon the shareholders, and Mr. Sartori and Mr. Hellman were to pay something to liquidate the indebtedness of the corporation. That plan did not go into effect. It wasn't necessary to levy the assessment because soon after that meeting was held, we were approached by the Tidewater Associated Oil Com-

(Testimony of Reuben Ingold.)

pany to purchase from us the reservation on their fee property. That was property that had originally been owned by the corporation and title had finally come to the oil company except for the reserve oil interests. I believe they proposed to us and paid \$7,500.00 for the oil interest.

After my first inspection I saw the orange grove again. It gradually got worse. We had another worry regarding that grove, and that is that the Angeles Mesa Land Company has a 70-acre grove immediately adjoining it across the street. We were fearful that with the further contamination of the San Fernando grove that the Angeles Mesa grove may be contaminated. That I think resulted in our final decision to have the trees taken out.

The Angeles Mesa grove was partially Navels, [89] partially Valencias and partially lemons. We found that the area was not adapted to the successful growth of Navel oranges. We finally had the Navels taken out of the Angeles Mesa grove as well as the San Fernando grove.

I have attended all the meetings of the directors between the time of my election and June 30, 1938.

Referring to Exhibit No. 2 which appears to be the minutes of a meeting of the directors of San Fernando Mission Land Company held under date of September 14, 1936, and more particularly to the reference in these minutes to sale of oil reservations, Lot 6 of Tract No. 10422 to the Associated

(Testimony of Reuben Ingold.)

Oil Company for \$7,500.00. I can't remember the exact date when the subject of that sale was first brought to my attention, but it was sometime within 30 or 45 days prior to this meeting. This came up after I had made my tentative arrangement with Mr. Sartori and Mr. Hellman. It was the receipt of this \$7,500.00 from that source which restored the corporation somewhat to its feet financially and made it unnecessary to levy the assessment.

In these same minutes there is some matter relative to authority to execute and deliver quitclaim deeds covering properties reserved for road purposes. The Title Guarantee & Trust Company owned certain land in the San Fernando Valley. That property had originally been sold by this company, and we had retained certain rights under road easements, and the title company wanted us to quitclaim from [90] time to time the rights that we had retained so that they could clear up the title to the property.

I asked authority of the Board to do that because we had requests from the title company to make such a quitclaim. We made that quitclaim and the San Fernando Mission Land Company received no consideration whatever for it.

There appears also in these minutes reference to an oil and gas lease to the Progressive Syndicate, a trust estate, as lessee, which matter was presented to the Board for its consideration.

There had been some negotiations with individu-

(Testimony of Reuben Ingold.)

als representing the Progressive Syndicate inquiring as to the possibility of leasing certain areas of the Sunshine Ranch, and I reported that to the Board and I think it was decided at that time that no lease would be entered into, and I notified the Progressive Syndicate or the people that I had been negotiating for their account, to that effect.

There is also some reference in these minutes to the extension of Laurel Canyon Boulevard through the orange grove. The City of Los Angeles had filed a condemnation to build Sepulveda Boulevard through the hill land, not through the orange grove, and had attempted to make some settlement with us regarding the lands that they had taken under this right of eminent domain. We couldn't agree at that time as to the amount of damages that we were entitled to, although at some later date we did come to an agreement and settled [91] it out of court.

On the Sepulveda condemnation I think we received around \$2,000.00. That was at a later date, however.

There is a reference in the minutes to a letter from the California Trust Company relative to oil rights reserved by the San Fernando Mission Land Company. The California Trust Company held or owned the surface rights to part of the Sunshine Ranch, which is a part of the 16,000 acres originally owned by this company, and the properties that they owned were incumbered by our reservation, oil rights, oil reservation. And they had been for some

(Testimony of Reuben Ingold.)

years attempting to clean up their title to that property, and this letter has reference to a request on their part asking us to give them a quitclaim deed to the mineral reservations so that they could clean up the title.

I don't remember that they offered us any consideration. It was my memory that they asked us to do it just to be good fellows, and we refused. That is the reservation on the 3,000 acres of the Sunshine Ranch. The corporation did not at that time consider that these reservations had any value. It wasn't that we felt that there was any value there by reason of any oil or gas that might be on the property. I think our decision was largely due to the fact that we had been informed that in the past when oil and gas reservations had been released we had been paid for that and that when this property that the California Trust Company [92] owned was originally sold, it was sold at a very low price, and that if they wanted the reservations released they should pay us for that purpose.

Referring to Exhibit 24, being minutes of special meeting of the board of directors of San Fernando Mission Land Company, held on the 10th day of November, 1937, and in particular to the reference to an oil lease on the part of the Sunshine Ranch to one William McClintock. I didn't meet Mr. McClintock in those negotiations at all. I did all of our negotiating with Mr. Freeman, an attorney representing Mr. McClintock, and the contract that

(Testimony of Reuben Ingold.)

Mr. McClintock had with the San Fernando Mission Land Company was through Mr. Freeman.

Mr. Freeman represented that he had a client by the name of McClintock who wanted to do a little oil speculating and wanted to drill a well on some of our property. I had checked Mr. McClintock and found that he was responsible. However, I had had enough experience in the past with oil leases to know that it isn't desirable to give a lease to any Tom, Dick or Harry, and expect performance; that the smart thing to do was to place the lease in escrow, and if they didn't perform within a due time to have the right to withdraw the lease from escrow and terminate it, and in that way not tangle up the title to the property. So I insisted in these negotiations that the lease be placed into escrow, the lease to be released from escrow when Mr. McClintock [93] had actually started to drill a well. The corporation received no consideration whatever for the execution of that lease and the placing of it in escrow. The corporation received no consideration whatever from McClintock in that transaction. The lease was never actually delivered to him.

In the minutes of the corporation under date of March 16, 1938, being Exhibit 25, there is a reference to an oil lease to one Howell. I represented the San Fernando Mission Land Company in some dealings with Mr. Howell. Mr. Howell, whom I had known for some time, asked for an oil lease on

(Testimony of Reuben Ingold.)

certain of the San Fernando Mission Company's mineral rights, and after some negotiation I told Mr. Howell that I would recommend to our board a lease with him for certain of those rights covering such properties, and at this meeting I did recommend to the board that we grant Mr. Howell a lease under certain terms and conditions, and was authorized to do so. No consideration was received by the corporation from Mr. Howell. He was to have six months without the payment of rental, and after six months he was to pay a dollar per acre every three months as rental for a continuation of the lease. That lease was executed, and it was delivered to Mr. Howell. He has made payments and is still making them. He was required under the lease to do drilling.

Other than the lease which has been introduced in evidence, there was no other contract with Mr. Howell relating to that transaction. Mr. Howell did not start to do any [94] drilling on the property so leased to him prior to June 30, 1938, nor did the corporation receive any information prior to the 30th day of June, 1938, from Mr. Howell or anyone else, that Mr. Howell intended to do any drilling on the property.

We have changed the terms of the lease we granted Mr. Howell at that time, subsequently, and have also granted certain reductions of rent. This was done subsequent to the 30th day of June, 1938. The lease as it stands in evidence is the only agree-

(Testimony of Reuben Ingold.)

ment of any kind with Mr. Howell prior to that date of June 30, 1938.

There is reference in these minutes, Exhibit 25, to the orange grove property. We were requested by the City of Los Angeles to grant a right of way through the orange grove property so that they could connect Laurel Canyon Boulevard with Sepulveda Boulevard. The corporation did not receive any consideration in this connection, although we made our deed conditional that the road would be built out of gas tax funds and not as a lien against the property.

The minutes of certain meetings of directors, about which I have testified, were the only meetings of the directors held between the time I became president and the 30th day of June, 1938, and as far as I can remember, these minutes reflect all the transactions that were had by the corporation during that time, other than the details that are reflected by the books of the corporation.

I know Mr. Hilker who testified here. He was in [95] charge of the books. They have come to my attention, and so far as I know they are correct.

I hold the privilege of practice before the Treasury Department of the United States. I have been an accountant for many years, as well as president of the Los Angeles Investment Company and several other corporations.

I engaged in income tax practice from 1918 to 1926. It was quite an extensive practice and not occasional.

(Testimony of Reuben Ingold.)

I was consulted at the time the San Fernando Mission Land Company fixed its declared value for 1938 capital stock for tax purposes. The return was filed, I believe, in July of 1938. The value was fixed at One Dollar.

I knew at that time the effect of a low declared value for capital stock purposes. I knew the result of declaring too low a value, that is, a value not commensurate with the real worth. I did not know the corporation was going to have a substantial income for the year 1938 at the time I authorized the declaration for capital stock tax purposes. If I knew, I would not have fixed a zero value.

I am familiar with the practice of land owning and selling companies with respect to oil reservations, meaning companies of that sort here in Southern California.

I can speak more directly of the practice with respect to the reserving of oil rights and mineral rights that we follow in the Los Angeles Investment Company. As a precautionary measure we withhold all mineral rights on any [96] property that we sell. There are two reasons for this: One is that in most cases your property is residential and you restrict the property against drilling for oil. We found out the best restriction and the safest precaution is to withhold the oil rights so that there is no incentive on anybody's part to drill.

Since the 30th day of June, 1938, we entered into some transaction with the Tidewater Associated Oil

(Testimony of Reuben Ingold.)

Company regarding the oil rights that had been reserved by the San Fernando Mission Land Company. I think it was the 26th of August, 1938. That is the date which the lease bears (Exhibit 30).

The first time that we had any knowledge that the Tidewater Associated Oil Company was interested in acquiring the oil rights on that land was on the 19th of August, 1938. Prior to that day, we had done nothing to find a purchaser or a person to take a lease on those particular oil rights.

On that day, Mr. Hilker, Mr. Hennessy and Mr. Gray—Mr. Hennessy and Mr. Gray were representing the Tidewater Associated Oil Company—called at my office and discussed the leasing of a part of our property to the Tidewater Associated Oil Company. All these parties were present at the conference. Mr. Gray, who was in charge of Tidewater leasing activities—Mr. Hennessy being their local attorney of the land and lease department—stated that they wanted to negotiate a lease on some property that we had the oil reser- [97] vation, and which was immediately adjoining the property that we had previously quit-claimed the reservation to them, and after some negotiation we arrived at a value for a lease on our property. We called it a bonus. We agreed to call a meet- in of our directors for the purpose of considering that.

Neither I nor anyone else under my direction for the San Fernando Mission Land Company made any investigation to determine whether there actually

(Testimony of Reuben Ingold.)

was oil in that land. We had made no inquiry whatever other than that which we made of the Tidewater Associated Oil Company at that conference.

The whole transaction was written into this one lease, Exhibit 30.

Mr. Gray was down here from San Francisco and stated that he would like to have it come to a conclusion before he left Los Angeles for San Francisco. I believe that we immediately held a directors meeting to consider the subject. We did not at that time know that the Tidewater Associated Oil Company had any showings of production on any of their land in that locality. On June 30, 1938, we had no knowledge or word that the Tidewater Associated Oil Company had any showing of production on their land in that locality.

Referring to Exhibit 26, the minutes of the meeting of the board of directors of the San Fernando Mission Land Company, held August 26, 1938, where there appears a refer- [98] ence to oil lease on Lot 7, Tract 10422, to Associated Oil Company. The transaction there reported is the same one concerning which I have just testified.

The consideration which we received from the Tidewater Associated Oil Company for this lease which was executed on the 26th day of August, 1938, other than the \$10.00 consideration recited in the lease, was \$20,000 in cash, and a speculative consideration of certain additional moneys to be paid out of oil, if, as, and when discovered.

(Testimony of Reuben Ingold.)

There has been no oil production whatever on the land. The \$20,000.00 was received.

The lease also provides for deferred rental in case the drilling wasn't started within a year, and the Tidewater Associated paid us that deferred rental at the rate of \$500.00 a month for a number of months.

None of this money was received or contracted to be received prior to the 30th day of June, 1938.

We had no inkling whatsoever that there would be transactions with the Associated Oil Company or any other person or firm respecting these oil reservations prior to the 30th day of June, 1938, or on that day itself.

I know Mr. Robert V. New. I have had some transactions with Mr. New concerning oil reservations that are owned by the San Fernando Mission Land Company.

I recognize Petitioner's Exhibit 26 as a copy of the minutes of the meeting of the board of directors of San [99] Fernando Mission Land Company held August 26, 1938.

In my transactions with Mr. New I entered into an agreement with him respecting services which he rendered or was to render the petitioner corporation. I discussed it with Mr. New prior to the board meeting of August 26, and after the board meeting I entered into an agreement with him. My first discussion with Mr. New was subsequent to the 19th of August, 1938.

(Testimony of Reuben Ingold.)

Other than as is set forth in these minutes (Exhibit 26), the San Fernando Mission Land Company did not at any time have any agreement with Mr. New to negotiate an oil lease on Lot 8 of Tract No. 10422.

This resolution which appears on pages 2 and 3 of Exhibit 26, is the only and complete agreement of the petitioner corporation with Mr. New.

I can't say that Mr. New approached us. I think I approached him in connection with the Associated lease. I asked Mr. New, who has been in the oil business most of his life, and whom I have known for some time, just exactly what provisions we should put in the lease if the board of directors felt that a lease was in order. This was subsequent to August 19, 1938.

I found Mr. New very helpful in giving me ideas how to protect the company in preparing the lease and in negotiating the various terms of a proposed lease. Naturally, in talking to him about it I exposed our negotiations with [100] the Associated Oil Company. He told me at one of those meetings that I had with him, all within a period of a few days, that he felt that if he was given a contract to lease some of our other property that he could among his friends in the oil industry secure a better lease than we could, not being acquainted in the oil industry. And these negotiations with Mr. New finally resulted in the agreement that I asked the board to approve on the 26th of August.

(Testimony of Reuben Ingold.)

Under this agreement which is set forth in the minutes of the directors meeting which appears as Exhibit 26, Mr. New secured a lease with the Shell Oil Company by which they paid us \$200.00 an acre bonus for a two-year lease covering nearly 400 acres of ground on which we had the oil reservations.

The copy of Exhibit 29 which I am being shown, which is an Oil and Gas Lease between San Fernando Mission Land Company, a California corporation, and Shell Oil Company, a California corporation, is a copy of the lease that Mr. New negotiated with the Shell Oil Company on our behalf.

The lease itself was finally determined by myself and Mr. Emerson. But in all essentials this lease is the outgrowth of Mr. New's negotiations.

I can't remember the exact date when negotiations were first commenced with the Shell Oil Company or any other company, with respect to the oil reservations that are leased in this lease, Exhibit 29, because Mr. New had the [101] preliminary negotiations with the Shell Oil Company.

I think he also talked with other companies, but it was after the date of the execution of the lease with the Tidewater Associated Oil Company.

Mr. New received compensation for the services which he rendered in connection with the lease transaction which finally came to a conclusion in the execution of the Oil and Gas Lease which is Exhibit 29, exactly on the basis outlined in the minutes of the board meeting of August 26th. He received nothing for the first \$25.00 an acre of bonus and 50

(Testimony of Reuben Ingold.)

percent of all bonus paid to the company in excess of \$25.00 an acre. I think some thirty-three thousand odd dollars total compensation.

On several occasions I have had transactions for the negotiation of oil leases, either for myself or other corporations, with persons other than Mr. New, who are in the line of business of negotiating oil leases.

There isn't any ordinary method of figuring the amount of compensation that is paid for this type of representation.

The basis of the compensation to Mr. New is set forth in the agreement which is a resolution in the minutes of that board meeting. The compensation there stated is the only compensation that he received.

(There was offered and received in evidence, a check, which was marked Petitioner's Exhibit No. 52, and made a part of this record. [102])

This check is the check by which Mr. New was paid. The amount is \$33,306.88.

At that time there were no further payments received by the petitioner corporation under the Shell lease, other than the amount of \$76,130.00. There were no further payments required to be made under that lease.

The lease was extended after the two years had elapsed on the payment of additional deferred drill-rental. That original rental was not a payment

(Testimony of Reuben Ingold.)

that was agreed to be paid in the original lease. It was arrived at by subsequent negotiations. Under the original lease there were no other sums to be paid other than the \$76,130.00, except the royalty in case of discovery of oil. No oil has been discovered to date. So that the sum of \$76,130.00 is the only money that San Fernando Mission Land Company has received under that particular lease.

The San Fernando Mission Land Company included that sum of \$76,130.00 as income in its return for the year 1938.

The corporation did not owe Mr. New any other money after payment to him of the sum that is represented by the check as it has been introduced in evidence, namely, \$33,306.88. Mr. New rendered all of the services which he was to have rendered the corporation when that lease with the Shell Oil Company was signed, and when the bonus of \$76,130.00 was actually paid. [103]

In my opinion the payment of \$33,306.88 to Mr. New was a reasonable fee commensurate with the services he rendered. I told Mr. New that we wouldn't expect to pay any brokerage or commission where the bonus was \$25.00 an acre or less. We were perfectly willing to pay 50 percent of any excess over \$25.00 an acre that we could get as a bonus. The property that was leased to the Shell was considerably further away from any development, from any property previously leased to the

(Testimony of Reuben Ingold.)

Associated, and it seemed to me that \$25.00 an acre was a reasonable bonus, and consequently I thought that if a man could develop a lease providing for a heavier bonus than that he was entitled to be very substantially compensated. I stated this substantially to the board of directors at the time they were asked to adopt the resolution respecting the employment of Mr. New which appears in Exhibit 26.

Mr. New was in no way interested in San Fernando Mission Land Company, not as a shareholder, nor an employee.

We had Mr. George Emerson assist in the preparation of the Shell Oil Company lease. He rendered a charge of \$250.00 for that service.

The statement you show me on the billhead of George H. Emerson, attorney at law, is the statement that Mr. Emerson rendered us for services in connection with the preparation of the Shell lease.

Check No. 6862 of the San Fernando Mission Land [104] Company which you show me, payable to George H. Emerson, in the sum of \$250.00 is the check with which his statement was paid.

(The said statement and check were offered and received in evidence as Petitioner's Exhibits Nos. 53 and 54, respectively, and made a part of this record.)

In my opinion the fee charged by Mr. Emerson in that connection was very reasonable and commensurate with the services rendered. The fee was

(Testimony of Reuben Ingold.)

paid entirely for services in connection with that particular lease. He had completed the services at the time his statement was rendered.

I have received compensation from the San Fernando Mission Land Company for my services in connection with its affairs. I can't tell exactly from memory, but I know there was one check for \$5,000.00 in December of 1938. This was the only payment prior to the closing of the calendar year 1938. At the end of the calendar year of 1938, I had no uncollected or accrued salary or commission or other compensation due me. This \$5,000.00 was paid in December of 1938. As to the period of time that I rendered these services for which I was compensated by the \$5,000.00, I don't remember that it was supposed to cover any particular length of time, except that the directors had in mind that it should cover all services rendered by me up until December 31, 1938, including a payment for my services in my original investigation that led to the election of a board of directors, and [105] the carrying on of the company from that time on, including the Associated and the Shell negotiations up until December 31st. This \$5,000.00 was the only compensation up to that time. I had not otherwise been compensated for my services in calling that meeting of shareholders and getting the company started again. Nor have I otherwise been compensated for my services in connection with the orange grove. When

(Testimony of Reuben Ingold.)

I accepted the \$5,000.00 I had in mind suggesting to the directors that when they should consider the question of compensation that it was to cover all services rendered by me up until December 31, 1933, that is, from the time that I took the office of president, and even before. The amount was not fixed by me. It was fixed by the board and I was asked if that was satisfactory. It was entirely satisfactory. I thought they were very liberal.

When I fixed the value of the stock at zero, I couldn't see that there was a possibility of the corporation having any income, and feeling that way I felt that there would be no penalty in valuing the stock at zero.

Prior to June 30, 1938, there were no preliminary conversations at all, or correspondence, respecting these oil reservations which later became the subject of the Tidewater Associated Oil lease and the Shell lease.

Cross Examination

By Mr. Taylor:

It is correct that the company had reserved oil [106] rights in approximately 3,000 acres of land prior to July 1, 1937, and which reservation continued throughout the calendar year 1938. And the company had reserved oil rights in that many acres of land, in excess of 3,000 acres.

As to why the oil companies were interested in leasing the company's property for oil development

(Testimony of Reuben Ingold.)

purposes, and as to whether or not there was a leasing program going on throughout the area, or whether it was restricted to the company's property, at that time we didn't know what was going on. We learned shortly after that. But at that time we didn't know what was going on. When I say "at that time", I mean at the time when we were first approached by the Associated Oil Company.

I don't know whether at the time when we entered into a lease on the 16th day of March, 1938, Petitioner's Exhibit 28, the oil companies, or any oil companies, were making efforts to lease properties other than the petitioner's herein for oil development purposes.

It is correct that I testified that the lease of March 16, 1938, petitioner's exhibit 28, fell through because of the default of Mr. McClintock, the lessee. The lease and escrow agreement provided that he would, within 90 days, actually start a well on the property. And if he had started a well on the property, under the escrow agreement he was to be furnished a copy of this lease that was signed. He did not start a well. He was to be furnished [107] with a copy. Both copies were in escrow, our copy and his copy. The lease was to be regarded in effect and it would be delivered to him if he had actually spudded in a well. I mean, he was to be furnished with a copy of the lease. It

(Testimony of Reuben Ingold.)

was in duplicate. It was to be a common and effective lease but only in case he spudded in.

The Howell lease, petitioner's Exhibit 28, entered into March 16, 1938, was consummated. It was carried through. The only purpose of our activities between July 1, 1937, and June 30, 1938, was with the intention of liquidating; at that time it was the only purpose of our activity. As to whether we entered into the Howell lease in pursuance of that purpose, the answer is Yes and No. It just happened to come up that way. We had an opportunity of leasing the property on a lease that provided for rentals for six months, and it looked to us like it was the proper thing to do. It hadn't changed our original purpose of liquidating as rapidly as possible.

I wouldn't say that we put off that purpose when we had the chance to make money through the execution of the Howell lease. We would still continue to sell whatever assets we had. The purpose of our entering the Howell lease was that we hoped that we would make money. In case oil was discovered, the Howell lease was to continue for a period of twenty years. I can't say that our purpose in liquidating was in any way aided by our entering into the Howell lease. If drilling operations were successful under the Howell lease [108] we could have then determined a value or distributed the oil rights to our shareholders probably easier

(Testimony of Reuben Ingold.)

than just distribute oil rights where no value existed behind them.

I first contacted Mr. New on the 20th or 21st or 22nd of August. I can't say the exact date. It was after the 19th, however. In 1938.

WALTER R. HILKER

a witness on behalf of Petitioner, resumed the stand and was further examined and testified as follows:

Direct Examination

By Mr. Tolin:

It was on August 19, 1938, that I first had any communication with the Tidewater Associated Oil Company, or any of its agents, representatives or employees, with respect to their negotiating an oil or gas lease. Mr. Gray and Mr. Hennessy of the Tidewater came down to my office, and after talking to them for a moment or two I saw that it was a matter for Mr. Ingold to hear. So I immediately telephoned him and the three of us went to his office and discussed it. That was the first that I knew of any desire on the part of anyone to negotiate such a lease.

Cross Examination

By Mr. Taylor:

I think the Shell Oil lease, petitioner's Exhibit 29, covered any of the oil rights that were covered

(Testimony of Walter R. Hilker.)

under the [109] lease which Mr McClintock failed to consummate. I wouldn't say that the Shell lease covered all the property covered by the McClintock lease. Part of it.

The San Fernando Mission Land Company never received any bonus or other payment as a result of the McClintock lease.

(At the conclusion of this testimony, the following proceeding among others took place.)

Mr. Tolin: That is all.

That closes our testimony, your Honor.

We note that Exhibits 39 to 49, inclusive, have been introduced but that we do not have copies, and we request that the exhibits might be withdrawn for the purpose of having copies made, the exhibits then to be filed wherever your Honor indicates.

The Member: Is that the correspondence?

Mr. Tolin: Yes, it is the correspondence, and the franchise tax returns.

The Member: You may withdraw them and substitute copies that are submitted to Mr. Taylor, so that he may register any objection as to the copies.

Mr. Taylor: Will you furnish me copies also?

Mr. Tolin: Certainly.

That might not be done before the Board has closed its calendar here. To where should we send our copies? [110]

The Member: If that occasion arises send them

to the Board in Washington. I hope, however, they will be given to the Clerk before we leave.

Mr. Tolin: We will undertake to do so. We know your Honor is expeditious, and we are not certain we can comply.

Mr. Taylor: Your Honor, I have introduced several income tax returns and capital stock tax returns. May they be withdrawn in accordance with the usual process and photostats substituted?

The Member: Full-sized photostats may be substituted. Has the Respondent any evidence?

Mr. Taylor: The Respondent rests, your Honor.

The Member: The case is submitted, and you may file your briefs in accordance with the rule.

(Hearing concluded.)

The above and foregoing is all the evidence introduced at the trial of said cause and all proceedings had at the trial thereof.

Petitioner and Appellant prays that the above Statement of Evidence be settled, allowed and approved by a member of the Board of Tax Appeals, as a true, full and correct and complete statement of all the evidence taken, for use on the appeal taken to the United States Circuit Court of Appeals for the Ninth Circuit. [111]

Dated: Sept. 4, 1942.

HARRY GRAHAM BALTER,
639 South Spring Street, Los
Angeles, California, Attor-
ney for Petitioner and Ap-
pellant.

All exhibits to be forwarded to Circuit Court in original form pursuant to its order dated 9/10/42.

[112]

Service of the foregoing Statement of Evidence and a receipt of a copy thereof, this 15 day of September, 1942, is hereby admitted and acknowledged.

(S) J. P. WENCHEL,

Chief Counsel, Bureau of Internal Revenue.

It is hereby stipulated that the above and foregoing Statement of Evidence is true and correct and may be approved by a member of the United States Board of Tax Appeals without notice.

Dated this 4th day of September, 1942.

HARRY GRAHAM BALTER,

Counsel for Petitioner.

(S) J. P. WENCHEL,

Chief Counsel, Bureau of Internal Revenue.

[Endorsed]: U.S.B.T.A. Filed Sept. 15, 1942.

[113]

[Title of Circuit Court of Appeals and Cause.]

ORDER TO SEND UP ORIGINAL EXHIBITS

On application of Harry Graham Balter, Counsel of record for Petitioner San Fernando Mission Land Company, and good cause appearing therefor:

It Is Ordered, that in addition to the Transcript of Record on Appeal in this action, the Clerk of the United States Board of Tax Appeals, at Washington, D. C., transmit to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, at San Francisco, California, the following Exhibits in their original form, referred to and designated in the Statement of Evidence in this action, to be by him safely kept and returned to the Clerk of the United States Board of Tax Appeals upon the final determination of this action in said United States Circuit Court of Appeals for the Ninth Circuit, namely: All of the Exhibits offered and received in Evidence as Petitioner's Exhibits Nos. 1 to 54, inclusive; and all of the Exhibits offered and received in evidence as Respondent's Exhibits Nos. A to M, inclusive.

It Is Further Ordered, that within such time as he may deem reasonable, the Clerk of this Court retransmit to the Clerk of the United States Board of Tax Appeals, such of the Exhibits as the Chief Counsel for the Bureau of *Internal desires* for examination and inspection in connection with the

preparation of the Board in behalf of the Respondent.

Dated: September 10, 1942.

(s) CURTIS D. WILBUR

Judge of the United States
Circuit Court of Appeals
for the Ninth Circuit.

[Endorsed]: Filed Sept. 10, 1942. Paul P.
O'Brien, Clerk.

A True Copy: Sept. 10, 1942.

Attest: [Seal] (s) PAUL P. O'BRIEN,
Clerk.

[Endorsed]: U.S.B.T.A. Filed Sept. 14, 1942.

[114]

United States Board of Tax Appeals

Docket No. 107149

SAN FERNANDO MISSION AND LAND COM-
PANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PRAECIPE FOR RECORD

(Designation of Parts of Record to be Cer-
tified)

To the Clerk of the United States Board of Tax
Appeals:

You are hereby requested to prepare and cer-
tify and transmit to the Clerk of the United States
Circuit Court of Appeals for the Ninth Circuit, at
San Francisco, California, with reference to peti-
tion to review heretofore filed by the Petitioner
in the above cause, a transcript of the record in
the above cause, prepared and transmitted as re-
quired by law and by the rules of said Court, and
to include in said transcript of record the follow-
ing documents, or certified copies thereof, to-wit:

1. The docket entries of all proceedings before
the Board of Tax Appeals.

2. All pleadings before the Board of Tax Ap-
peals, as follows:

(a) Petition and request for redetermination. [115]

(b) Answer of the Respondent.

3. The Memorandum of Findings of Fact and Opinion of the Board of Tax Appeals.

4. The Decision of the Board of Tax Appeals.

5. Petition for Revision and Review.

6. Order Denying Revision.

7. Order Denying Review.

8. Petition for Review and Assignment of Errors filed by the Petitioner in the above case.

9. Notice of filing Petition for Review, and Acknowledgement of Service of said Notice.

10. Substitution of Counsel.

11. Order Enlarging time to file Transcript of Record, etc.

12. Statement of Evidence.

13. Certified copy of Order of United States Circuit Court of Appeals for the Ninth Circuit Sending up Exhibits.

14. This Praecipe and Affidavit of Service by Mail.

(s) HARRY GRAHAM BALTER

639 South Spring Street

Los Angeles, California

Counsel for Petitioner

Copy mailed to J. P. Wenchel, Chief Counsel,
Bureau of Internal Revenue, Sept. 4, 1942.

[Endorsed]: U. S. B. T. A. Filed Sept. 9, 1942.

[116]

[Title of Board and Cause.]

CERTIFICATE OF CLERK TO
TRANSCRIPT OF RECORD

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 116A, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praeceptum in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 17th day of September, 1942.

[Seal]

B. D. GAMBLE,

Clerk, United States Board
of Tax Appeals.

[Endorsed]: No. 10272. United States Circuit Court of Appeals for the Ninth Circuit. San Fernando Mission Land Company, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed October 2, 1942.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

United States Circuit Court of Appeals
for the Ninth Circuit
Docket No. 10272

SAN FERNANDO MISSION LAND COM-
PANY,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

POINTS ON WHICH APPELLANT INTENDS
TO RELY ON APPEAL AND DESIGNA-
TION OF PARTS OF RECORD WHICH
APPELLANT BELIEVES NECESSARY
FOR CONSIDERATION THEREOF (Rule
19).

In conformity with the provisions of Subdivision
6 of Rule 19 of rules of practice of the Circuit
Court of Appeals for the Ninth Circuit, appellant
sets out:

I.

Points on Which Appellant Intends to
Rely on Appeal

The points on which appellant intends to rely on
appeal are as follows:

1. The Board of Tax Appeals erred in deter-
mining that appellant was subject to excess profits
taxes for the calendar year 1938.

2. The Board of Tax Appeals erred in failing

to find that in the capital stock tax year ending June 30, 1938, appellant was not "carrying on or doing business" within the meaning of the applicable statutes and regulations, and decisions interpreting such statutes and regulations.

3. That the Board of Tax Appeals erred in failing to find that the appellant's activities during the period from July 1, 1937, to June 30, 1938, exclusive, was not the carrying on and doing business for profit, but was, on the contrary, for the purposes of liquidation.

4. That the Board of Tax Appeals erred in misapplying to the facts of the case at bar, the holding of the Supreme Court of the United States in the case of *Magruder vs. Washington, Baltimore, and Annapolis Realty Corporation*, decided April 13, 1942.

5. That the Board of Tax Appeals erred in failing to apply to the appellant the provisions of the exemptions provided for in Article 43(b) of Regulation 64 (1938 edition).

II.

Designation of Parts of Record Which Appellant Believes Necessary for Consideration Thereof

For the consideration of the points on which appellant intends to rely on appeal, it is designated that the entire record as certified to the Clerk of the United States Circuit Court of Appeals of the Ninth Circuit by the Clerk of the United States Board of Tax Appeals be printed, save and except

the original exhibits which by order of court have been transmitted in their original state, for reference and examination by the Court.

HARRY GRAHAM BALTER

Attorney for Appellant

[Endorsed]: Filed Oct. 19, 1942.

No. 10272.

IN THE

17
United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

SAN FERNANDO MISSION LAND COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S BRIEF.

HARRY GRAHAM BALTER,
639 South Spring Street, Los Angeles,
Attorney for Petitioner.

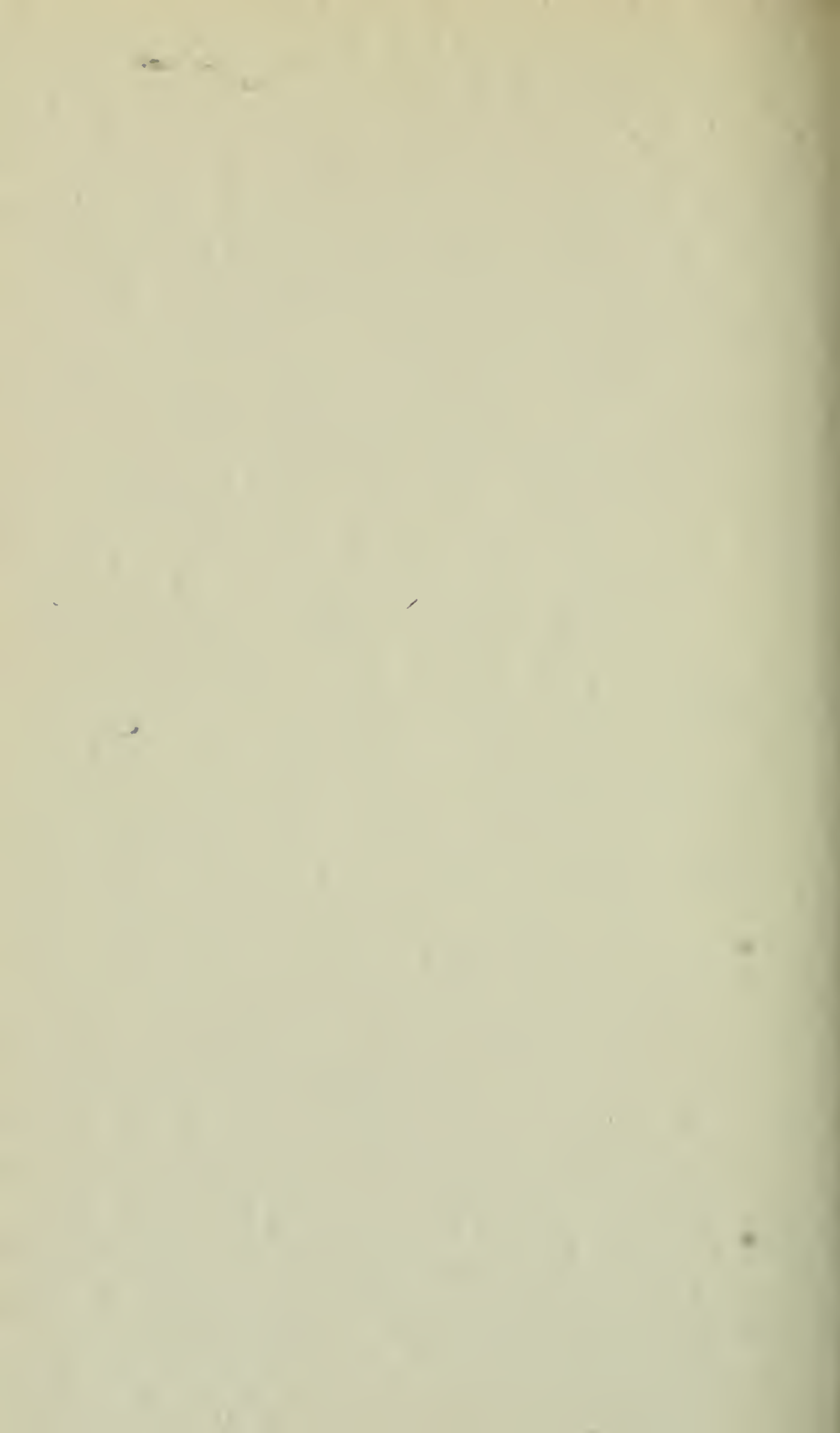
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PAUL P. O'BRIEN,

Parker & Baird Company, Law Printers, Los Angeles

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No. 10272.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

SAN FERNANDO MISSION LAND COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S BRIEF.

I.

Preliminary Statement and Basis of Jurisdiction.

This is an appeal taken from a decision of the United States Board of Tax Appeals holding that there is a deficiency in Petitioner's income tax liability and excess profits tax liability for the calendar year 1938. The Commissioner determined a deficiency in income tax in the amount of \$4,508.56 and a deficiency in excess profits tax in the amount of \$8,035.64. The deficiency in income tax for the calendar year 1938 was based on the disallowance by the Commissioner of commissions paid by Petitioner

during the calendar year 1938 in the sum of \$33,306.88, and the disallowance of attorney's fees in the sum of \$250.00, both incurred by Petitioner in connection with oil exploration leases executed by Petitioner as lessor during the calendar year 1938. As far as this appeal is concerned, Petitioner is abandoning its claim that the disallowance by the Commissioner of these two items was improper for the practical reason that the Board's Opinion so treats the claimed expenses that the deduction is not completely disallowed, but merely deferred to a subsequent year.

The sole question to be decided on this appeal is the correctness of the determination by the Commissioner that Petitioner was subject to excess profits taxes for the calendar year 1938 in the sum of \$8,035.64.

As appears from an examination of the statutes and regulations, *post*, pages 5 *et seq.* Petitioner would be subject to an excess profits tax for the calendar year 1938 if during any part of the capital stock tax year ending June 30, 1938, Petitioner was "carrying on or doing business" within the meaning of Sec. 601(a) of the Revenue Act of 1938.

Petitioner is a corporation duly organized and existing under and by virtue of the laws of the State of California, with its principal office in the City of Los Angeles, State of California. Petitioner filed its income tax return for the calendar year 1938 and its capital stock tax return for the capital stock tax year ending June 30, 1938, with

the Collector of Internal Revenue at Los Angeles, California, and within the jurisdiction of the United States Circuit Court of Appeals for the Ninth Circuit.

The Commissioner determined a deficiency in excess profits tax liability for the year 1938 in the sum of \$8035.64, based on a tax of 12% of \$66,963.04 (the net income found by the Commissioner subject to excess profits tax), and the Commissioner denied Petitioner's contention that the corporation was exempt from the excess profits tax as one that was not during the capital stock tax year ending June 30, 1938, "carrying on or doing business" [Tr. pp. 8-12].

Petitioner thereupon filed its petition with the United States Board of Tax Appeals for the redetermination of the deficiency determined by the Commissioner of Internal Revenue.

The case was tried before the Board in Los Angeles, California, on February 6 and 9, 1942, the Honorable John H. Sternhagen presiding.

II.

Specification of Errors Relied Upon.

The points upon which Petitioner intends to rely in this appeal are as follows:

1. The Board of Tax Appeals erred in determining that Petitioner was subject to excess profits taxes for the calendar year 1938.

2. The Board of Tax Appeals erred in failing to find that in the capital stock tax year ending June 30, 1938, Petitioner was not "carrying on or doing business" within the meaning of the applicable statutes and regulations, and decisions interpreting such statutes and regulations.

3. The Board of Tax Appeals erred in failing to find that the Petitioner's activities during the period from July 1, 1937, to June 30, 1938, inclusive, were not the carrying on and doing business for profit, but were, on the contrary, for the purposes of liquidation.

4. The Board of Tax Appeals erred in misapplying to the facts of the case at bar, the holding of the Supreme Court of the United States in the case of *Magruder v. Washington, Baltimore and Annapolis Realty Corporation*, decided April 13, 1942.

5. The Board of Tax Appeals erred in failing to apply to the Petitioner the provisions of the exemptions provided for in Article 43(b) of Regulation 64 (1938 edition).

III.

Statutes and Regulations Involved.

The statutes and regulations which are pertinent to the issues in this appeal are as follows:

Revenue Act of 1938 (52 Stat. 447, ch. 289):

“SEC. 601. CAPITAL STOCK TAX.

(a) For each year ending June 30, beginning with the year ending June 30, 1938, there is hereby imposed upon every domestic corporation with respect to carrying on or doing business for any part of such year an excise tax of \$1 for each \$1,000 of the adjusted declared value of its capital stock.”

“SEC. 602. EXCESS PROFITS TAX.

(a) If any corporation is taxable under section 601 with respect to any year ending June 30, there is hereby imposed upon its net income for the income-tax taxable year ending after the close of such year, an excess-profits tax equal to the sum of the following:

6 per centum of such portion of its net income for such income-tax taxable year as is in excess of 10 per centum and not in excess of 15 per centum of the adjusted declared value;

12 per centum of such portion of its net income for such income-tax taxable year as is in excess of 15 per centum of the adjusted declared value.”

Regulations 64 (1938 Edition)—Relating to the Capital Stock Tax:

“Article 1. *Effective date of the tax.*—The capital stock tax imposed by section 601 of the Revenue Act of 1938 is in effect on and after July 1, 1937, and applies with respect to each year ending June 30, beginning with the year ending June 30, 1938.”

“Art. 41. *Nature and rate of tax.*—The tax is an excise tax imposed with respect to carrying on or doing business during a taxable year ending June 30, or any fractional part thereof. It is an excise tax upon the exercise of the privilege of doing business and not upon the business itself and is imposed upon each corporation with respect to carrying on or doing business and not upon each business carried on. If more than one corporation is engaged in carrying on a single business, each must file a return and pay the tax. The tax is imposed at the rate of \$1 for each full \$1,000 of the adjusted declared value of the capital stock. The tax may not be apportioned under any circumstances. If a corporation is engaged in business for any portion of a taxable year, liability for the tax is incurred for the entire taxable year.”

“Art. 42. *Doing business.*—The term ‘business’ is very comprehensive and embraces whatever occupies the time, attention, or labor of men for profit. Accordingly, regardless of the nature of its activities, any corporation organized for profit and carrying out the purpose of its organization is doing business within the meaning of the Act. Similarly, even if not organized for profit, any corporation which engages in activities ordinarily carried on for profit is doing business. It is immaterial whether the activities result in a profit or a loss, or whether the cor-

poration has been successful in its enterprise, or that because of unfavorable business conditions, no operations are carried on for a particular period. No particular amount of business need be done, nor is it necessary that the business be continuous throughout the taxable year.

The case is exceptional in which the activities of a corporation organized for profit do not amount to doing business within the meaning of the Act. Such a case is generally limited to one in which the corporation is not pursuing the ends for which organized, *i. e.*, profit.”

“Art. 43. *Illustrations.*—(a) *General.*—In general ‘doing business’ includes any activities of a corporation whether it engages in—

* * * * *

(5) the orderly liquidation of property by negotiating sales from time to time as opportunity and judgment dictate and distribution of the proceeds as liquidation is effected—for example, the liquidation of an estate, or of properties taken over from another corporation, or of the shareholders’ fractional interests in particular property;

* * * * *

(b) *Exceptions.* — Ordinarily the exceptions to ‘doing business’ are restricted to limited activities of a corporation. For example—

(1) A corporation is not subject to the tax if its corporate powers are limited to the mere owning and holding of property and the distribution of its avails, or, although incorporated for the purpose of doing business, if it has retired from the business for which it was organized and has reduced its activities to the

mere ownership and holding of property, the distribution of its avails, and doing only such acts as are necessary to the maintenance of its corporate existence and the private management of its purely internal affairs. However, a corporation which has retired from its principal business is subject to the tax if, nevertheless, it engages in other business activities or maintains its organization for the purpose of continued effort in the pursuit of profit or gain.

* * * * *

(3) A corporation will not be regarded as 'doing business' if it had no activities during the entire taxable year, because it has—

(a) become dormant; or

(b) completed its business, as, for example, where a real estate subdivision has been developed, sold and reduced to cash; or

(c) abandoned its business, as, for example, where prospective oil properties are proven worthless."

"Art. 44. *Declared value*.—In its return for each declaration year, a corporation must declare a definite and unqualified value for its capital stock. The declaration of value must be made in terms of United States dollars and be specific, as, for example, \$10,000, or 'Zero,' in the event it is desired to indicate no value. Inasmuch as the declared value can in no case be less than zero, a declaration of a deficit or minus figure shall be considered a declaration of 'Zero.'

* * * * *

T. D. 4829, 1938-2 D. B., 98 (Declared Value Excess Profits Tax Regulations).

IV.

Statement of the Case.

As stated above, if the Petitioner was "carrying on or doing business" for any part of the period from July 1, 1937, to June 30, 1938, then under section 601(a) and section 602(a) of the Revenue Act of 1938, Petitioner became liable for an excess profits tax on its net income for the calendar year 1938, computed in accordance with section 602(a). The sole issue is, therefore, whether the Petitioner was or was not "carrying on or doing business" during the period of July 1, 1937, to June 30, 1938.

The facts are entirely undisputed, consisting of the oral testimony of Petitioner's assistant secretary and Petitioner's president and corroborative documentary evidence, consisting principally of corporate records, minutes of stockholders' and of directors' meetings, leases, and miscellaneous correspondence with stockholders, etc. The crux of the difference of attitude between the Petitioner and the Commissioner lies in a difference in interpretation and emphasis of the uncontraverted facts.

Petitioner claims that during the capital stock tax year in question it was not "carrying on or doing business" within the meaning of the basic tax statute and the Commissioner's own Regulations as they have been interpreted by the courts; that whatever activities took place were reasonably related to a well-defined prior program for liquidation and gradual distribution of its corporate assets to its stockholders. The Commissioner, on the other hand, claims that the corporation carried on sufficient activities during the period in question to constitute "carrying on or doing business." The event which focused attention upon the particular year in question was the

receipt by Petitioner during the calendar year 1938, but subsequent to June 30, 1938, of the sum of \$20,000 in cash and a speculative consideration of certain moneys to be paid out of oil if, as, and when discovered, in connection with a lease executed by Petitioner to the Tidewater Associated Oil Company on the 26th day of August, 1938, and the additional sum of \$76,130.00 as a bonus paid to Petitioner by the Shell Oil Company in connection with the lease executed to it on the 25th day of November, 1938. Both of these leases were for oil exploration purposes. Neither during the calendar year 1938 nor to date has any oil been discovered on Petitioner's property.

Rather than to restate the factual background leading to this controversy, all of which appears in condensed form in the Statement of Evidence [Tr. pp. 45-117], there is presented below a condensation in summary form of the principal facts which are necessary for the determination of the issue of "carrying on or doing business." In presenting this summary we have given fair emphasis to all facts which have been referred to in earlier proceedings by Petitioner, by the Commissioner, and by the Board in its Findings of Fact [Tr. pp. 14-17] and in its Opinion [Tr. pp. 17-19]:

1. The petitioner is a California corporation, organized on December 3, 1904. [Petitioner's Exhibit No. 3.]

2. The purposes for which the Petitioner was organized were the buying and selling of land and water and the subdividing of land for sale, and purposes incidental thereto. [Petitioner's Exhibit No. 3.]

3. The original capital stock of the Petitioner was One Million Dollars, divided into 10,000 shares, all of which were issued. [Petitioner's Exhibits No. 3, 4, and 20.]

4. During the year 1905, the Petitioner acquired approximately 16,000 acres of land and commenced actively to engage in the business for which it was organized. [Petitioner's Exhibit No. 5.]

5. The Petitioner actively pursued the purposes for which it was organized and by the year 1923, the Petitioner had disposed of all but approximately 200 acres of its original 16,000 acres of land. [Tr. pp. 56-57.]

6. From incorporation until January 29, 1923, the Petitioner paid cash dividends to its stockholders in the sum of \$2,050,000.00. [Petitioner's Exhibits 7 and 9 to 23, both inclusive.]

7. On May 20, 1918, the Petitioner paid a dividend to its stockholders of \$1,000,000.00 in land. [Petitioner's Exhibits No. 7 and 15.]

8. No dividends were paid by Petitioner between January 29, 1923, and June 30, 1938, the closing date of the capital stock tax year in question. [Tr. p. 53.]

9. On April 17, 1919, the Board of Directors of the Petitioner appointed a committee for the purpose of devising and submitting a plan of segregating or distributing all of the remaining lands of the corporation. [Petitioner's Exhibit No. 14.]

10. On January 24, 1921, the Board of Directors of the Petitioner adopted a resolution to reduce the Petitioner's capitalization from \$1,000,000.00 to \$100,000.00, and the Petitioner's capital was formally reduced in conformity thereto. [Petitioner's Exhibits No. 20 and 4.]

11. No meetings of the Board of Directors were held during the period between February 2, 1927, and September 14, 1936. [Tr. p. 68.]

12. On September 14, 1936, four of the seven directors of the Petitioner had previously died and had not been replaced. Vice-President J. F. Sartori had for-

gotten that he held that office. The Petitioner's president had died and had not been replaced. [Tr. pp. 91-92.]

13. No meetings of the stockholders of the Petitioner were held between May 28, 1918, and September 14, 1936. [Tr. p. 68.]

14. In 1936, R. F. Ingold, on behalf of the Angeles Mesa Land Company, a 10% stockholder of Petitioner, in undertaking to collect advances made by it to Petitioner over a period of years for conserving Petitioner's assets, learned that Petitioner had no funds with which to pay its obligation. A plan was devised whereby a stockholders' meeting would be called, directors elected, an assessment against stockholders levied to furnish funds to pay the debt, and a dissolution of the corporation be then made as rapidly as possible. [Tr. pp. 91-94.]

15. California Franchise Tax Returns filed for the years 1926, 1927, and 1928, stated that the Petitioner was being wound up and was practically liquidated. [Petitioner's Exhibits No. 47, 48 and 49.]

16. Correspondence between the Petitioner and several stockholders between March 16, 1933, and November 22, 1937, indicate that the Petitioner was inactive and that it was the intent of the Petitioner to liquidate. [Petitioner's Exhibits No. 39 to 46, both inclusive.]

17. The intention of the management of the Petitioner between 1925 and 1938 was to sell the remaining properties of the Petitioner and to spend a minimum in maintenance to preserve the properties until sold. [Tr. pp. 59-60.]

18. The only reason the Petitioner was not dissolved prior to 1938, was because it was not practicable to distribute its few remaining properties among its stockholders and the management attempted to sell its properties so that a cash liquidation might be made. [Tr. p. 80.]

19. During the six and one-half year period from January 1, 1931, to June 30, 1937, the beginning date of the capital stock tax year in question, the Petitioner's entire activities consisted of the following:

Its Income was derived from sale of oranges and lemons produced from a grove located on part of the original land owned by the Petitioner; one sale of its real property for \$1,500.00 in 1932; one sale of oil reservations in 1936 for \$7,500.00; release of an oil lease in 1931 for \$10.00; and rent of pasture land in 1935 for \$75.00.

Its Expenses consisted of maintenance of the orange and lemon grove; real estate taxes; payment of state franchise tax, and federal capital stock tax; interest on money owed; administration expense paid for the year 1936; and an inconsequential item of \$43.10 of general expenses. [Petitioner's Exhibit No. 38 and Tr. pp. 64-68.]

20. The Land and Mineral Interests in Land owned by the Petitioner on July 1, 1937, were the same as were owned by the Petitioner on December 31, 1930. [Tr. pp. 62-63.]

21. The financial condition of the Petitioner between December 31, 1930, and July 1, 1937, indicates that its assets were practically the same, and its liabilities were increased on the latter date principally because of unpaid real estate taxes extending over the period. [Petitioner's Exhibits No. 36 and 37.]

22. The Petitioner acquired no property subsequent to 1925. [Tr. pp. 79-80.]

23. The income derived by the Petitioner subsequent to July 1, 1938, arose out of events occurring after July 1, 1938, and were unforeseen by the Petitioner or its officers on or prior to June 30, 1938. [Tr. pp. 102-103.]

24. The negotiations with the Tidewater Associated Oil Company resulting in an oil and gas lease bearing date of August 26, 1938 [Petitioner's Exhibit No. 30],

did not commence until August 19, 1938, and that was the first knowledge the officers of Petitioner had of this transaction. [Tr. p. 103.]

25. On August 26, 1938, Petitioner entered into an agreement with Robert V. New to pay him a commission on any oil and gas lease to be negotiated by him on certain property owned by the Petitioner. New was to receive no compensation for his services in the event the bonus payment for the lease amounted to \$25.00 per acre or less, and he was to receive 50% of whatever consideration was received in excess of \$25.00 per acre. [Petitioner's Exhibit No. 26.]

26. Robert V. New negotiated an oil and gas lease with the Shell Oil Company, dated November 25, 1938, as a result of this employment. [Tr. p. 107.]

27. The oil and gas lease executed between the Petitioner and the Shell Oil Company, dated November 25, 1938, covered 380.65 acres of land, and a bonus of \$200.00 per acre was paid upon its execution, making a total bonus paid thereon of \$76,130.00 in 1938. [Petitioner's Exhibit No. 29.] The bonus above mentioned represented all sums required to be paid by the Lessee during the term of the lease, excepting royalties on oil and gas when, as and if produced on the property, the lease provided that drilling operations should commence on or before two years from the execution of the lease, and the lease was to be in effect for so long as drilling operations continued. [Petitioner's Exhibit No. 29.]

28. Robert V. New was paid the sum of \$33,306.88, in 1938, based solely on the agreement terms and on the \$76,130.00 bonus received from the Shell Oil Company. [Petitioner's Exhibit No. 52.]

29. No oil has been discovered on the property leased to the Shell Oil Company to date. [Tr. p. 105.]

30. The Petitioner fixed a capital stock tax value of zero in its 1938 Capital Stock Tax Return which it filed in July, 1938, and it would not have done so had

it known it would have received any income in 1938.
[Tr. p. 102.]

31. The Statement of Financial Condition as of June 30, 1938, reflects no substantial changes from that of July 1, 1937. [Petitioner's Exhibits No. 37 and 51.]

32. There is set out below, in a detailed breakdown, the financial condition of Petitioner as of July 1, 1937, as reflected in its financial statement [Petitioner's Exhibit No. 37]:

(a) On July 1, 1937, the Petitioner's financial statement consisted of the following:

<u>ASSETS</u>	
Cash in Bank	\$ 479 65
Land	
Parcel 1—Orange and Lemon Grove	\$52 500 00
Parcel 2—Unplotted Hill Lands	13 800 00 66 300 00
	<hr/>
Mineral Interests in Land	1 00
	<hr/>
<u>Total Assets</u>	<u>\$66 780 65</u>
	<hr/> <hr/>

<u>LIABILITIES AND CAPITAL</u>	
Liabilities—Accrued Taxes and Accounts Payable	\$ 8 218 60
Net Worth	58 562 05
	<hr/>
<u>Total Liabilities and Capital</u>	<u>\$66 780 65</u>
	<hr/> <hr/>

[Petitioner's Exhibit No. 37.]

(b) "Land—Parcel 1—Orange and Lemon Grove," on July 1, 1937, was a "tail-end" piece of the original

16,000 acres of property acquired by the Petitioner. [Tr. p. 59.] The grove was planted to Navel oranges and this locality was not a good navel district. [Tr. p. 59.] An overhead sprinkling system prevented proper cultivation of the land. [Tr. p. 59.] It was infested with scale and Johnson grass. [Tr. p. 59.] The Petitioner received notices from the Horticultural Department, State of California, to thoroughly fumigate and take care of the grove, or make some other disposition of it. [Tr. p. 62.] The Petitioner had spent a minimum amount of money in maintaining the grove because the Petitioner did not have the funds. [Tr. p. 60.] Property taxes were not paid for many years. [Tr. p. 60.] It had been apparent that the grove was not self-sustaining and could never be operated at a profit. [Tr. p. 75.] During the fiscal year ended June 30, 1938, the trees were pulled out at a cost of \$456.75 and the grove abandoned. [Tr. p. 75.] The grove was sold to the State for delinquent taxes and has never been redeemed. [Tr. p. 76.]

(c) "Land—Parcel 2—Unplotted Hill Lands," on July 1, 1937, was a "tail-end" piece of the original 16,000 acres of property acquired by the Petitioner. [Tr. p. 60.] This property was unimproved, without water, utilities, or streets. [Tr. p. 60.] It was remote from any established residential section. [Tr. p. 60.] During the fiscal year ended June 30, 1938, a sale of 4.75 acres of this land was made at a gross price of \$2,365.00. [Tr. p. 72.] The remaining land has not been sold because no buyer could be found. [Tr. p. 73.]

(d) "Mineral Interests in Land," on July 1, 1937, was a reservation of mineral interests in approxi-

mately 3,000 acres of land previously sold by the Petitioner. The land was part of the original 16,000 acres of property acquired by the Petitioner. [Tr. p. 62.] The oil reservations owned by the Petitioner were originally withheld for 50 years in connection with a sale of certain land to The Sunshine Co. in 1919, because the sale of the surface was made at a very low price. [Tr. p. 98 and Petitioner's Exhibit No. 31.] The withholding of oil rights is common practice in order to take away the incentive to drill for oil on residential property such as was the property of the Petitioner. [Tr. p. 102.] No oil has ever been found on the Petitioner's property. [Tr. p. 105.] To June 30, 1938, the Petitioner had no knowledge of any oil showings on adjacent land. [Tr. p. 104.] No oil surveys have ever been made on the property of the Petitioner. [Tr. p. 89.] The oil reservations never had other than a speculative or unknown value at any time. [Tr. p. 87.] The Petitioner never released any oil reservations except to the owners of the surface rights. [Tr. p. 90.] During the fiscal year ended June 30, 1938, the Petitioner made only one sale of its oil reservations and that was to the surface owner, John O'Melveny, for the sum of \$1,180.00. [Tr. p. 89.] During the fiscal year ended June 30, 1938, the Petitioner proposed to enter into an oil and gas lease with one William McClintock but this lease was never delivered and the Petitioner never received any consideration for it. [Petitioner's Exhibit No. 24 and Tr. pp. 98-99.] During the fiscal year ended June 30, 1938, the Petitioner leased certain mineral rights to one A. Llewellyn Howell for which it received no consideration at time of execution and which provided for deferred rental. [Petitioner's Exhibit No. 28 and Tr. pp. 99-100.]

(e) The income and expenses of the Petitioner for the fiscal year ended June 30, 1938, consist of the following:

<u>INCOME</u>	
Final Proceeds from Sale of Oranges and Lemons	\$ 51 87
Refunds—Packing House and Railroad Claims	39 01
Profit on Sale of 4.75 Acres of Land	1 890 00
Proceeds from Sale of Oil Reservation	1 180 00
Rental of Pasture	50 00
Received from Agricultural Conservation	59 78
Total Income	<hr/> \$3 270 66

<u>EXPENSES</u>	
Orange Grove Expenses	\$1 565 34
Real Estate Taxes— Hill Land	745 11
Cost of Pulling Trees— Grove Abandoned	456 75
General Expenses	79 14
Franchise Tax	25 00
Capital Stock Tax	1 00
Title Charges on Sale of Property	25 00
<u>Total Expenses</u>	<hr/> 2 897 34
Net Income for Period	<hr/> \$ 373 32

[Petitioner's Exhibit No. 50.]

(f) Final Proceeds from Sale of Oranges and Lemons, in the amount of \$51.87, represents the entire income from the grove for the period until the trees were pulled out. [Tr. p. 72.]

(g) Refunds from Packing House and Railroad Claims, in the amount of \$39.01, represent repayments of withholds in prior years and for fruit spoilage and were final payments received by the Petitioner. [Tr. p. 72.]

(h) Rental of Pasture Land in the amount of \$50.00 was received for the use of the Petitioner's hill lands during the fiscal year. [Tr. p. 73.]

(i) Proceeds received from the Agricultural Conservation Program, in the amount of \$59.78, was for non-planting of the orange grove. [Tr. p. 73.]

(j) Orange Grove Expenses, in the amount of \$1,565.34, represents expenses incurred prior to the time the grove was abandoned. The expenses represent the minimum expense possible. Property taxes reflected as expenses were not paid. [Tr. p. 74.]

(k) Real Estate Taxes—Hill Land, in the amount of \$745.11, represents the current year's taxes, the only portion of which was paid was that on the 4.75 acres of land sold during the period. [Tr. p. 75.]

(l) General Expenses, in the amount of \$79.14, consist of surveying and blue printing the 4.75 acres of land sold during the period. [Tr. p. 76.]

(m) Franchise Tax, in the amount of \$25.00 is the minimum payment required by the State of California to maintain the Petitioner's corporate franchise. [Tr. p. 76.]

(n) Capital Stock Tax, in the amount of \$1.00, represents the 1937 Capital Stock Tax declaration. [Tr. p. 76.]

(o) Title Charges, in the amount of \$25.00, is in payment of costs in connection with the sale of the 4.75 acres of land. [Tr. p. 76.]

33. The only other transactions engaged in by Petitioner in the period of July 1, 1937, to June 30, 1938, not reflected in the financial statement outlined in detail hereinabove were the following:

(a) The Petitioner loaned the Angeles Mesa Land Co., a stockholder, the sum of \$1,500.00 during the fiscal year ended June 30, 1938, on open account without interest, being purely an accommodation loan. [Tr. p. 77.]

(b) During the fiscal year ended June 30, 1938, the Petitioner paid certain liabilities outstanding against it on July 1, 1937, which represented transactions prior to July 1, 1937. [Tr. pp. 77-78.]

(c) The only other transactions of the Petitioner during the fiscal year ended June 30, 1938, consisted of action by the Board of Directors in granting a right of way to the City of Los Angeles through the Petitioner's grove property for road purposes for which is received no consideration. [Tr. p. 101 and Petitioner's Exhibits No. 24 and 25.]

34. (a) Its Board of Directors at a meeting held on July 2, 1917, approved the sale of certain land, subject to the reservation by the Petitioner of all mineral rights. [Petitioner's Exhibit 10.]

(b) A directors' meeting, held on January 10, 1918, authorized the execution of an oil lease for a one-eighth royalty to be paid to Petitioner. [Petitioner's Exhibit 11.]

(c) A directors' meeting held on April 17, 1919, authorized the sale of three parcels of Petitioner's real estate, subject, in each case, to the reservation of all oil, gas and mineral rights. [Petitioner's Exhibit 14.]

(d) On May 23, 1919, a deed to certain of Petitioner's lands was executed to the Sunshine Company, a California corporation, reserving to the Petitioner, for a term of fifty years, all oil and gas rights. [Petitioner's Exhibit 31.]

(e) The directors' meeting of August 14, 1925, considered certain proposed oil leases upon the Petitioner's property. [Respondent's Exhibit H.]

(f) The directors' meeting of February 2, 1927, considered proposed oil leasing propositions submitted to the Petitioner by the Title Insurance and Trust Company, and by the Shell Oil Company. The meeting approved the execution, in consideration of the sum of \$2,940.00, of quitclaim deeds releasing oil rights to certain acreage which had been previously sold by the Petitioner. The meeting also voted not to authorize the execution of any more oil releases by the Petitioner "for the present, at least." The meeting authorized the president of the Petitioner to enter into negotiations with the Shell Oil Company for the leasing of certain lands of the Petitioner for oil drilling purposes, provided that the Shell Oil Company would offer not less than \$12,000.00 to be paid in advance as a bonus, and a one-sixth royalty. The meeting refused to quitclaim the Petitioner's oil and gas rights under the land conveyed to the Sunshine Company by the deed of May 23, 1919, Petitioner's Exhibit 31. [Petitioner's Exhibit 6.]

(g) A meeting of the Board of Directors held on September 14, 1936, considered an offer of \$7,500.00 made by the Associated Oil Company for oil rights reserved by the Petitioner under a part of the Sunshine Ranch. The meeting also authorized the sale of these oil rights for the best price obtainable. The meeting also considered and decided not to execute a proposed oil and gas lease to the Progressive Syndicate as lessee, covering approximately 858 acres of the Sunshine Ranch. The meeting also considered a request by the California Trust Company relative to oil rights reserved by the Petitioner under certain other acreage of the Sunshine Ranch, and decided that no disposition of these oil rights would be made at the time. [Petitioner's Exhibit 2.]

35. Petitioner received income in 1938, 1939 and 1940 from its leases, executed after June 30, 1938, and paid dividends to its stockholders in each of these years. This income, however, was not received from oil royalties, but only from bonuses and deferred rentals. [Petitioner's Exhibit 27 and Respondent's Exhibits J, K, L, and Tr. p. 84.]

V.

ARGUMENT.

Petitioner Was Not "Carrying on or Doing Business" Between July 1, 1937, and June 30, 1938, Within the Meaning of Section 601(a) of the Revenue Act of 1938, as Interpreted by the Courts.

SUMMARY:

A. *The broader criteria for "carrying on or doing business" for capital stock tax purposes as declared by the Courts.*

1. Each case must depend upon the particular facts presented to the Court.
2. The activities of the corporation and the situation must be judged as a whole; likewise, the past history of the corporation should be read and studied for the light it may throw on its current dealings or its inactivity.
3. A corporation may well reach a stage of quietude and passivity for a particular capital stock tax period, bringing it within the exemption from the tax, and yet the same corporation may resume its activities shortly thereafter with a sufficient tempo to bring itself within the tax liability.
4. A strong indication of not "carrying on or doing business" would be the corporation's failure to invest its income in new enterprises, limiting itself rather to the distribution of its income to its stockholders.
5. If the corporation has abandoned its charter purposes for profit and is engaged principally in liquidating or "distributing its avails," then it is no longer "carrying on or doing business."

B. *More specific guides for determining whether a corporation is "carrying on or doing business" for capital stock tax purposes.*

1. A corporation is not "carrying on or doing business" merely because it maintains its corporate existence, or in addition thereto does whatever is reasonably necessary towards that end, as for example, maintains an office, pays taxes, holds meetings of stockholders or directors, pays its officers, realizes profits from its own investments, etc.
2. A corporation is not "carrying on or doing business" for capital stock tax purposes even though it takes reasonably necessary steps to maintain its properties and conserve its assets.
3. A corporation is not "carrying on or doing business" for capital stock tax purposes even though it engages in business activities and realizes profits from its own assets, if these activities are not in furtherance of the purposes for which it was created, but rather are reasonably directed toward a program of liquidating its business and distributing its assets to its stockholders.
4. If there is found to be an intention to liquidate, whether formally expressed or implied from its activities, then a corporation is not "carrying on or doing business" merely because it puts forth its best efforts in disposing of its assets for revenue purposes.

C. *Cases most nearly analogous to the facts disclosed by the record herein, where courts have held the corporation was not "carrying on or doing business" for capital stock tax purposes.*

- D. *The Supreme Court decision in Magruder v. Washington, etc. Realty Corporation in no way changes the applicability of the rules theretofore enunciated by the Court in so far as the facts reflected in the record herein are concerned; and the Board of Tax Appeals was clearly in error when it based its ruling adverse to Petitioner on the authority of the Magruder case.*
- E. *Viewed in the light of the applicable judicial guides which have interpreted Section 601(a) of the Revenue Act of 1938, the record in this case indisputably shows that the Petitioner was not "carrying on or doing business."*
1. The record shows a clearly defined intention by Petitioner to liquidate its assets as rapidly as conditions warranted.
 2. Such activities as Petitioner engaged in, during the capital stock tax year in question, were not carried on in furtherance of the purposes for which it was incorporated, but rather were reasonably related to (a) the maintenance and preservation of its properties and assets, and (b) the orderly disposal and liquidation of its properties and assets; and
 3. The isolated transactions during the taxable year in which Petitioner granted an option or lease for oil exploration purposes did not indicate the seeking of a new source of prolonged business, but rather merely an attempt to create an additional value to the assets which it had for some time past been seeking to liquidate.

Petitioner Was Not "Carrying on or Doing Business"
Between July 1, 1937, and June 30, 1938, Within
the Meaning of Section 601(a) of the Revenue Act
of 1938, as Interpreted by the Courts.

A. The Broader Criteria for "Carrying On or Doing Business" for Capital Stock Tax Purposes as Declared by the Courts.

There is as much difficulty reflected in judicial attempts to fix guideposts for determining "carrying on or doing business" in the rather narrow field of capital stock tax liability as we know exists in generally determining a "doing business" status of corporations for other purposes.

There would, therefore, be no useful purpose served in an exhaustive recital of the array of decisions which have dealt with the problem of whether a particular corporation was or was not "carrying on or doing business" for a particular capital stock tax year.

Rather, we shall first attempt to discuss a few leading Supreme Court decisions which generally have laid down interpretive guides, and then go on to analyze a selected number of Circuit Court of Appeals, District Court, and Court of Claims cases which we are satisfied are very close to the factual situation with which we are here dealing. There is a long series of Supreme Court cases which dealt with the problem of determining whether or not a corporation was "doing business" within the meaning of the Corporation Tax Law of 1905. Although the present capital stock tax and its coordinate, the excess-profits tax, were originally enacted on June 16, 1933, as Title II of the National Industrial Recovery Act, the interpretive problem in both instances has been treated as identical.

Of the earlier Supreme Court cases, four may be singled out as determinative, namely, *McCoach v. Minehill etc. Rd.*

Co. (228 U. S. 295); *Edwards v. Chile Copper Co.* (270 U. S. 452); *United States v. Emery, Bird, Thayer Co.* (237 U. S. 28), and *Von Baumbach v. Sargent Land Co.* (242 U. S. 503, 516).

In *McCoach v. Minehill etc., supra*, the Court laid down this guide:

“The distinction is between (a) the receipt of income from outside property or investments by a company which is otherwise engaged in business, in which event the investment income may be added to the business income in order to arrive at the measure of the tax; and (b) the receipt of income from property or investments by a company that is not engaged in business except the business of owning the property, maintaining the investments, collecting the income, and dividing it among its stockholders. In the former case, the tax is payable; in the latter, not.” (p. 308.)

In the case of *United States v. Emery, Bird, Thayer Co., supra*, Mr. Justice Holmes added the sage observation:

“. . . The question is rather what the corporation is doing than what it could do.”

In *Edwards v. Chile Copper Co., supra*, Mr. Justice Holmes further pointed out that:

“The cases must be exceptional when such activities of such corporations do not amount to doing business in the sense of the statute. The exception ‘when not engaged in business’ ordinarily would seem pretty nearly equivalent to when not pursuing the ends for which the corporation was organized, in the case where the end is profit.”

The interpretive rules, however, became best crystalized in the most-often-referred-to case of *Von Baumbach v. Sargent Land Co., supra*, where the Court said:

“It is evident from what the Court has said in dealing with the former cases that the decision in each in-

stance must depend upon the particular facts before the court. The fair test to be derived from the consideration of all of them, is between a corporation which has reduced its activities to the owning and holding of property and the distribution of its avails and doing only the acts necessary to continue that status, and one which is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain and such activities as are essential to those purposes."

This judicial exemption from the "carrying on or doing business" status of a corporation which is principally engaged in activities related to the holding of its properties and the "distribution of its avails" became the basis for a regulatory exemption adopted by the Commissioner of Internal Revenue as Regulations 64 (1938 edition), Article 43(b) (1), set out *supra*, page 7.

Summarizing, the broader guides for determining whether a corporation is or is not "carrying on or doing business" for capital stock tax purposes are as follows:

1. Each Case Must Depend Upon the Particular Facts Presented to the Court. (This, of Course, Accounts in Part at Least for the Great Diversion in Decisions Reached by Trial Courts Since No Two Cases Are Identical in All Details.)
2. The Activities of the Corporation and the Situation Must Be Judged as a Whole; Likewise, the Past History of the Corporation Should Be Read and Studied for the Light It May Throw on Its Current Dealings or Its Inactivity.
3. A Corporation May Well Reach a Stage of Quietude and Passivity for a Particular Capital Stock Tax Period, Bringing it Within the Exemption From the Tax, and Yet the Same Corporation May Resume Its Activities Shortly Thereafter With a Sufficient Tempo to Bring Itself Within the Tax Liability.
4. A Strong Indication of Not "Carrying on or Doing Business" Would Be the Corporation's Failure to Invest Its Income in New Enterprises, Limiting Itself Rather to the Distribution of Its Income to Its Stockholders.
5. If the Corporation Has Abandoned Its Charter Purposes for Profit and Is Engaged Principally in Liquidating or "Distributing Its Avails," Then It Is No Longer "Carrying on or Doing Business."

B. More Specific Guides for Determining Whether a Corporation Is "Carrying On or Doing Business" for Capital Stock Tax Purposes.

Going from the general to the specific, we are able with fair definiteness to formulate a few more tests anent "carrying on or doing business" which bear more closely to the facts of our particular case:

1. **A Corporation Is Not "Carrying on or Doing Business" Merely Because It Maintains Its Corporate Existence, or in Addition Thereto Does Whatever Is Reasonably Necessary Towards That End, as for Example, Maintains an Office, Pays Taxes, Holds Meetings of Stockholders or Directors, Pays Its Officers, Realizes Profits From Its Own Investments, etc.**

United States v. Hotchkiss Redwood Co. (C. C. A. 9) (1928), 25 Fed. (2d) 958 (analyzed *post*, page 37);

Ambergris Consolidated Mining Co. v. United States (D. C. Idaho) (1939), 27 F. Supp. 968.

Automatic Fire Alarm Co. of Delaware v. Bowers (D. C. S. D. New York) (1931), 51 Fed. (2d) 118:

Taxpayer borrowed small sums temporarily from its subsidiaries, for which it paid no interest, and which it used in paying dividends. Occasionally, also, taxpayer made small temporary loans to its subsidiaries. They, however, were for convenience only, no interest being charged or paid. Activities also included that of a holding company of stock of a subsidiary operating company, the purchase of a building for a subsidiary for \$325,000 on account of which it loaned subsidiary \$180,000; taxpayer likewise sold stock of a total of \$294,150. *Held*: Not "carrying on or doing business."

United States v. Emery, Bird, Thayer Co., supra:

A corporation which leased its property and franchises for a long term and ceased to pursue the purposes

for which it was organized, but which maintained corporate existence, received rents, made investments, distributed income among stockholders, held annual stockholders' meetings, maintained a board of directors, etc. *Held*: Not "carrying on or doing business."

McCoach v. Minehill etc. Rd. Co., supra:

Taxpayer leased its railroad and ceased operations, but received rentals called for by lease, deposited money at interest, maintained offices, paid salary to officers and clerks, kept stock books for transfer of capital stock, which stock was bought and sold on the market. *Held*: Not "carrying on or doing business."

2. **A Corporation Is Not "Carrying on or Doing Business" for Capital Stock Tax Purposes Even Though It Takes Reasonably Necessary Steps to Maintain Its Properties and Conserve Its Assets.**

Cannon v. Elk Creek Lumber Co. (C. C. A. 7) (1925),
8 Fed. (2d) 996:

Corporation was organized for purpose of bidding in lands. The lands were bid in and the corporation continued to hold the lands waiting for favorable opportunity for disposing of them, and distributing the proceeds, in the meantime paying all taxes, patrolling and protecting property from fire and trespassers and cruising the timber so that the boundaries and the timber possibilities might be known, but not cutting any timber or renting or otherwise making use of the timber or land, save in one instance keeping a few houses on some of it occupied at a nominal rent to prevent their going to ruin. . . . The operation of the timber properties as such was not in contemplation of or for income or profit therefrom, save that it was hoped to dispose of the properties as stated and efforts were made to interest others in their purchase, failing in which the

corporation might operate if sufficient outside capital therefor could be secured. . . . *Held*: Neither the hope that some day someone will come along and buy them out, and thus enable them to distribute the proceeds among the original bondholders coupled with some efforts to bring this about, nor the alternative hope that sometime someone would supply them with sufficient capital to operate the properties is being “engaged in business” within the meaning of the quoted statute.

Del Norte v. Wilkinson (D. C. E. D. Wis.) (1928),
28 Fed. (2d) 876;

Mid-West Steel Corp. v. O'Toole (D. C. W. D. Pa.) (1940), 1940 *Prentice-Hall F. T. S.*, par. 63,028.

3. A Corporation Is Not “Carrying on or Doing Business” for Capital Stock Tax Purposes Even Though It Engages in Business Activities and Realizes Profits From Its Own Assets, If These Activities Are Not in Furtherance of the Purposes for Which It Was Created, but Rather Are Reasonably Directed Toward a Program of Liquidating Its Business and Distributing Its Assets to Its Stockholders.

Union Land & Timber Co. v. United States
(analyzed *post*, page 33);

Estate of Isaac G. Johnson v. United States
(analyzed *post*, page 35);

United States v. Hotchkiss Redwood Co. (analyzed
post, page 37);

S. Makransky & Sons, Inc. v. United States (D. C. E. Div. Pa.) (1940) (1940 *Prentice-Hall F. T. S.*, par. 62,905):

“In the present case the plaintiff corporation was not engaged in the business for which it was organized. On the contrary, its activities during the tax period were confined to the holding of property, some of which

was being liquidated, the payment of taxes and the payment of insurance premiums by means of the advances received from the insured persons and from policy loans. . . . The maintenance of the policies was deemed to be temporary pending a final study and determination by the officers and directors of the best method of disposing of them, and there is nothing to indicate that there existed any other purpose than the ultimate liquidation of the company." *Held*: Not "carrying on or doing business" for capital stock tax purposes.

Western Shore Lumber Co. v. United States (D. C. N. Dist. So. Div. Calif. (1941), 1941 *Prentice-Hall F. T. S.*, par. 62,943 (on appeal) (analyzed, *post*, page 37).

4. If There Is Found to Be an Intention to Liquidate, Whether Formally Expressed or Implied From Its Activities, Then a Corporation Is Not "Carrying on or Doing Business" Merely Because It Puts Forth Its Best Efforts in Disposing of Its Property or Makes Sales of Its Assets, or Even Leases All or Part of Its Assets for Revenue Purposes.

Lane Timber Co. v. Hynson (C. C. A. 5) (1925), 4 F. (2d) 666:

"Owning land is not doing business, nor is paying taxes. Most owners of land, whether a corporation or not, would be willing to sell it at a profit. In our opinion the mere fact that the plaintiff selected agents who might be able to sell its land does not make it liable."

Western Shore Lumber Co. v. United States, supra.

C. Cases Most Nearly Analogous to the Facts Disclosed by the Record Herein, Where Courts Have Held the Corporation Was Not "Carrying On or Doing Business" for Capital Stock Tax Purposes.

Since each decided case must turn on its own peculiar facts, there would be little to gain from an exhaustive treatment of all of the decisions. We have tried, however, to cull from the mass a limited number of decisions which we feel are most closely in point with the facts of our own case as reflected in the record, and feel therefore that they are entitled to great deference.

1. *Union Land and Timber Co. v. United States*, 65 Ct. of Cl. 129, 6 A. F. T. R. 7444:

In that case the plaintiff was incorporated in 1906, had been in business for a number of years with the usual broad charter powers and its main business had been the acquisition of turpentine lands. In 1917, the corporation resolved to liquidate. The activities after this determination to liquidate were described as follows:

"An office at Mobile, Ala., was continued by the president of the corporation, assisted by one stenographer, designated as secretary. All other officials were dispensed with; and sustained and continued efforts from that time on prevailed to realize the best possible price for the lands owned by the corporation. In the course of so dealing some turpentine leases, or rights to extract turpentine from turpentine trees, were let; and of course efforts were made to get the best possible price for the fee to the lands owned. If offers for the lands or turpentine rights were considered inadequate they were refused and more advanced prices sought. The progress of disposition has been tedious and de-

layed. To dispose advantageously for creditors of a large acreage of turpentine lands at a time when the markets were depressed and demand therefor seriously curtailed has involved years of time and effort, and though the majority of the lands and rights have been sold there still remain holdings undisposed of."

In finding for the plaintiff taxpayer the Court stated as follows:

"A mere repetition of the application of the taxing act to varying conditions of fact, as reflected in numerous opinions of the courts, will serve no special purpose. It is sufficient to observe that the issue is one of fact within the guiding principles of settled law. As said in the case of *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 516 (U. S. Tax Cases, 590): 'The fair test to be derived from a consideration of all of them is between a corporation which has reduced its activities to the owning and holding of property and the distribution of its avails, and doing only the acts necessary to continue that status, and one which is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain and such activities as are essential to those purposes.'

"We think this case comes squarely within the exception which exempts a liquidating corporation from the capital stock tax. The defendant predicates a contrary opinion upon the fact that at times offers for lands were refused, and negotiations continued to obtain more; that turpentine rights were sometimes let, and finally that the inherent nature of the plaintiff's business was of necessity the doing of the very things it did do—*i. e.*, buy and sell land and turpentine rights, etc., for profit. The charter rights of the corporation

disclose its purposes, and among them was the purchase and sale of lands and turpentine rights; but the continuance of these activities as a going concern, promoted for the purpose of paying dividends to its stockholders, and doing the same things to acquire sufficient funds to pay creditors are distinctly different. One contemplates the present and the future, looks toward an indefinite continuance of business activities. The other is predicated in this case largely upon the misfortunes of the past, and looks exclusively to a disposition to the best advantage of what the corporation has and discontinuing business. No business enterprise could discontinue advantageously without putting forth its best efforts to realize the greatest possible sum for its assets, and the mere fact that in the course of such a proceeding profits may at times be realized, though in this case none are proven, does not designate the transaction as 'doing business' within the intent of the taxing act."

"The plaintiff has not acquired additional lands, it has not paid dividends to stockholders, and all it has done is to dispose, as rapidly as mature judgment and the state of the market would warrant, of all of its tangible investments. Judgment will be awarded the plaintiff."

2. *Estate of Isaac G. Johnson v. United States* (Ct. of Cl.), 37 F. Supp. 617:

In that case the plaintiff corporation was incorporated in 1904 for the purpose of dealing in real estate. The facts in this case, as cited by the Court, are as follows:

"The 'purpose' clause of plaintiff's certificate of incorporation granted broad powers usual to real estate companies, and from its incorporation down to 1929 the

plaintiff engaged in the general activities permitted. In 1929, by a resolution, the plaintiff declared that—

* * * it is the policy of this corporation gradually to liquidate its affairs as its property can be advantageously disposed of and distribute its assets among its stockholders, * * * and distributed a liquidating dividend among its stockholders. Thereafter, the plaintiff discontinued many of the activities previously engaged in and generally reduced its operation to the maintenance and management of its remaining properties and the making of such sales as were deemed advantageous. It continued in that manner to and including the year 1936, and for some time later, but maintained an office with an accountant, two stenographers, and one or two groundkeepers; receiving rents, making repairs, considering and undertaking agency contracts and projects for the favorable marketing of its holdings. During this period it was generally engaged in transactions which had for their purpose the ultimate disposition of existing holdings at a profit. At no time within this period did plaintiff purchase or otherwise acquire any new property, or engage in any activities not necessary for the preservation and care of the property which it then held, and the revenues which might be derived therefrom.”

The Court thereupon held that the corporation was not “carrying on or doing business” for the reason that the operations and transactions of the corporation were carried on merely for the purpose of reducing the property of the estate to a form in which it could be readily distributed among the heirs and such activities do not constitute a business.

As in the *Union Land & Timber Co.* case, the Court in the *Johnson* case disregarded individual acts but considered the operations as a whole. It is respectfully submitted that the activities in the *Johnson* case likewise exceed in volume and variety the transactions of the Petitioner in the case at bar.

3. *United States v. Hotchkiss Redwood Co., supra:*

The corporation was organized for the sole purpose of owning and holding a tract of timber land and reselling the same as a whole. Besides maintaining its corporate existence, it issued bonds in the sum of \$550,000 secured by a lien on its properties for the purpose of redeeming an earlier bond issue of its predecessor company; levied and collected assessments on its capital stock to pay taxes, interest on bonded indebtedness, and other necessary charges and expenses; to avoid condemnation proceedings, it sold a strip of land for highway purposes for \$5,000; paid \$50.00 per month salary to secretary and \$150.00 per month was paid to president "on account of office expenses"; from time to time corporation has carried on negotiations through its president with prospective purchasers and brokers, looking to the sale of its lands as a whole, but no person or agent has been employed for that purpose; land was never advertised for sale, and no part sold except the strip for highway purposes. *Held:* Not "carrying on or doing business."

4. *Western Shore Lumber Co. v. United States* (D. C. N. D. So. Div. Calif.) (1941) (on appeal) *supra:*

For tax period in question assets of company consisted, as for many years previously, solely of approximately

12,500 acres of timber lands in one county in California and approximately 550 acres of timber lands in another county, and certain cash in bank accounts. During the four year period in question, the company carried on no activities other than the holding and safeguarding of these timber properties and occasional negotiations looking toward their disposition as a whole. During this period there were no meetings of stockholders, but there were three meetings of the board of directors. The action taken at two of these meetings were solely in routine corporation matters, such as the filling of vacant offices, authorizing the employment of auditors, etc., and the only non-routine business transacted at the third directors' meeting was the ratification of a supplemental agreement with the Santa Cruz Lumber Co. by which that company was permitted to cut timber under its existing contract on certain additional land of the taxpayer. Otherwise, taxpayer carried on no activities, sold no lands, etc. Company did, however, employ a secretary at \$25.00 per month and a caretaker at \$1800.00 per year. The company paid taxes, interest on its indebtedness, miscellaneous office expenses, etc. The company had carried on negotiations looking toward the sale of its property as a whole and on several occasions gave options to prospective purchasers, although no option was given during the tax period in question. The board of directors gave consideration and thought to a method for liquidating the property but was unable to arrive at any program by which it could be liquidated except by a sale to public bodies or by a program of logging contracts which the company did not care to undertake. There were, how-

ever, some receipts from stumpage contracts between the company and the Santa Cruz Lumber Company on a remote part of its properties. Income from these contracts was used to pay taxes upon the property and current expenses, but the taxpayer itself did not engage in logging or stumpage operations. *Held*: That a corporation such as the plaintiff which has reduced its activities to the ownership and the holding of property and the distribution of its avails, and to only such actions as are necessary to the maintenance of the corporation and the private management of its purely internal affairs is not carrying on or doing business within the meaning of the capital stock tax act.

“The liability of the plaintiff for capital stock taxes must be decided by the purpose for which the corporate organization was maintained and where, as in the present case, there was no intent during the taxable period in question or for many years prior to such period to carry on any active enterprise and the sole purpose of the corporation was to hold on to timber lands and effect a sale of the whole thereof as soon as a fair price could be obtained, the proceeds to be distributed to the stockholders and there was no purpose or activity which constituted efforts or the use of capital in the pursuance of gain or profit, then plaintiff was not carrying on or doing business under the terms of the capital stock tax law.”

- D. The Supreme Court Decision in *Magruder v. Washington, etc., Realty Corp.* in No Way Changes the Applicability of the Rules Theretofore Eunciated by the Court in So Far as the Facts Reflected in the Record Herein Are Concerned; and the Board of Tax Appeals Was Clearly in Error When It Based Its Ruling Adverse to Petitioner on the Authority of the *Magruder Case*.

It should be clear from a reading of Board Member Sternhagen's opinion [Tr. p. 17] that the principal basis for his adverse ruling to the Petitioner was his reliance upon the decision of the Supreme Court in *Magruder v. Washington, Baltimore & Annapolis Realty Corporation*, 86 L. Ed. 858, 62 S. Ct. 922, 316 U. S. 69, decided April 13, 1942, which decision as the record shows was handed down only a few weeks before the Board Member rendered his own opinion in the case at bar. [Tr. p. 19.] Mr. Sternhagen at the very beginning of his opinion summarily disposes of the heart of Petitioner's contention as follows:

"The petitioner's claim that in the capital stock tax year ending June 30, 1938, it was not carrying on or doing business rests upon the view that its activities of that period were incidental to a long-existing intention to liquidate and were so slight as to be negligible and hence should, for present purposes, be disregarded. As to the intention to liquidate, whatever may have been said as to its significance under earlier decisions must now be revised in view of *Magruder v. Washington, Baltimore & Annapolis Realty Corporation*, U. S. (April 13, 1942); for that decision held a corporation which was expressly formed for liquidation to be subject to the capital stock tax. In the 'nebulous field of confusion' affecting this subject, Article 43(a)

(5) of Regulations 64 was held to be controlling, and in that article liquidation was not *per se* enough to support exemption.” [Tr. p. 17.]

There can be no question but that the decision against Petitioner was crucially influenced by the Board Member's belief that the *Magruder* case controlled. The balance of the Board Member's opinion is clearly anti-climactic.

Nor can there be any question but that the Board Member must be charged with a serious misinterpretation and misapplication of the holding of the *Magruder* case.

The crux of the Board Member's analysis of the ruling in the *Magruder* case is that the term “liquidation” as given in Regulations 64, Article 43(a) (5) means liquidation activities of every kind; and according to him it therefore follows that a corporation such as the Petitioner here, which has definitely discontinued the purposes for which it was originally organized, and is now in the process of orderly liquidation, is nevertheless controlled by the provision of Article 43(a) (5) making the corporation subject to capital stock tax, and is not entitled to the exemption from this tax expressly provided for in Article 43(b) (2).

Article 43(a) provides: “In general ‘doing business’ includes any activities of a corporation whether it engages in”

And subdivision (5) gives as an illustration of a corporation which would be considered as “doing business” one which is engaged in “the orderly liquidation of property by negotiating sales from time to time as opportunity and judgment dictate, and distributing the proceeds as

liquidation is effected—for example the liquidation of an estate, or of properties taken over from another corporation or of the shareholders' interest in particular property."

On the other hand, Article 43(b) (2) grants exemption from the tax to a corporation which is engaged in "the distribution of the avails of property and the doing only of such acts as may be necessary for the maintenance of the corporate status in the case in which the corporation either was organized for or has reduced its activities to, the mere owning and holding of specific property."

Obviously, as Board Member Sternhagen interpreted the ruling in the *Magruder* case there would be no meaning or vitality to Article 43(b) (2) under whose protective cloak Petitioner has constantly sought shelter from the tax. Even a cursory examination of Mr. Justice Murphy's concise opinion in the *Magruder* case should show the error of Mr. Sternhagen's analysis. The Washington, Baltimore and Annapolis Realty Corporation was formed for the exclusive and express purpose of liquidating the assets of another corporation, namely, the Washington, Baltimore & Annapolis Railway Co. It is clear then that liquidation was the very purpose for which the taxpayer was organized. It was equally plain that Article 43(a) (5) was directly in point covering just such a liquidating corporation. The only problem presented to the Court was whether Article 43(a) (5), being an administrative regulation ought to be sufficiently persuasive so as to be controlling. In that connection, Mr. Justice Murphy aptly said:

"Article 43(a) (5) is both a contemporary and a long-standing administrative interpretation, having been

in effect in substantially the same form since 1918, except for the period from 1926 to 1933 when the tax was not imposed. We are of the opinion that it is valid as well as applicable. The crucial words of the statute 'carrying on or doing business' are not so easy of application to varying facts that they leave no room for administrative interpretation or elucidation. To be sure, in many, if not in most instances the factual situation will be so extremely unusual there will be no doubt as to whether a corporation is doing business or not. But the nuances of facts between the two extremes have produced a nebulous field of confusion which has been recognized by courts striving to fit close cases into one category or the other. Interpretative regulations, such as Article 43(a) (5) are appropriate aids towards eliminating that confusion and uncertainty. . . ."

Mr. Justice Murphy in no way devitalizes the validity of Article 43(b) (2). On the contrary, he specifically refers to the regulation, but holds it not to be applicable to a corporation actively engaged in the business for which it was organized, even though that business happens to be the liquidation of its own assets:

"We find without substance respondent's assertions that Article 43(b) (2) is inconsistent with Article 43(a) (5) and that it more exactly fits the facts of this case. During the period in question respondent did not fall into that state of quietude, covered by the specific language of Article 43(b) (2), in which it was merely owning and holding specific property and distributing the resulting proceeds On the contrary, respondent was actively engaged in fulfilling the purpose of its creation, the liquidation of its holdings for the best obtainable price."

In fact it is equally deducible from this opinion that where properly applicable, Article 43(b) (2) is as fully entitled to be considered "an appropriate aid toward eliminating that confusion and uncertainty" which this "nebulous field" has produced, as was in fact accorded by the Court to Article 43(a) (5) on a set of facts where that regulation clearly applied.

The limited number of subsequently decided cases which have referred to the *Magruder* decision, unequivocally point out that the aura of non-taxability has in no way been taken away by that decision from corporations which are not organized for the specific purpose of liquidation but which are in fact liquidating and "distributing its avails."

The North Pennsylvania Rd. Co. v. Rothensies (D. C. E. Div. Pa., May 29, 1942) (45 F. Supp. 486):

"The Supreme Court held that the liquidating activities of the taxpayer constituted doing business in accordance with interpretive regulation Article 43(a) (5) *supra*, and that Article 43(b) (2) was not applicable. . . . In my opinion the operations of the plaintiff in the instant case fall within the description 'that state of quietude' so aptly phrased in the *Magruder* opinion."

The Court further held that Article 43(b) (2) was valid in line with the specific holding in the *Magruder* case.

Goodyear Investment Co. v. Collector, (D. C. N. D. E. Div. Ohio) (August 3, 1942), 1942 *Prentice-Hall F. T. S.*, par. 62,948;

Continental Baking Corp. v. Higgins (C. C. A. 2) (July 24, 1942), 1942 *Prentice-Hall F. T. S.*, par. 62,884:

“The recent decision of the Supreme Court in *Magruder, Collector v. Washington, B. & A. Realty Corp.*, 315 U. S.—April 13, 1942, is not *contra*. There a corporation organized to liquidate rights-of-way, terminals, and other real estate which had been purchased at a foreclosure sale by a bondholders’ committee, the Washington, B. & A. Realty Co. proceeded to sell the property acquired. It was held that the liquidating corporation was carrying on business within the meaning of the statute. The liquidating corporation was not a holding company at all but one whose corporate activities were liquidation through sale of real estate and whose organization was for that very purpose. The activities of the plaintiff were only those of a quiescent holding company such as fall within the exceptions set forth in Treasury Regulation 64, Article 43(b) (2) and not within Article 43(a) (5) as did those dealt with in *Magruder, Collector v. Washington, B. & A. Realty Co.*, *supra*.”

We submit in summary, that the Board Member was clearly in error as to his interpretation and application of the *Magruder* case; and submit further that his failure to clearly base his decision upon any other ground constitutes persuasive evidence of the untenability of the Commissioner’s position in face of the declared law prior to the *Magruder* decision and his own Regulations.

E. Viewed in the Light of the Applicable Judicial Guides Which Have Interpreted Section 601 (a) of the Revenue Act of 1938, the Record in This Case Indisputably Shows That the Petitioner Was Not "Carrying On or Doing Business".

Above, we have analyzed to the best of our ability the most pertinent of the vast body of cases which have struggled with the concept of "carrying on or doing business" for capital stock tax purposes. Yet, as confused as the mass appears to be, there does emerge one crystal-clear principle which is armored with uncontravertible judicial authority: namely, *that where the corporation has indicated its intent to discontinue the business for which it was organized and thereafter to "hold on" until it is able to liquidate and "distribute its avails," then the corporation during this passive and "quiescent" period is not considered to be "carrying on or doing business" even though: (1) it may be engaging in such activities as are reasonably necessary to effectuate its liquidation, or (2) it may be engaging in such activities as are reasonably necessary to preserve its properties and conserve its assets, and (3) even though the process of liquidation may be slow, tedious, and proceeds over a period of years.*

It is on the strength of this crucial test that Petitioner has insisted that it had not for a period of eighteen years prior to the taxable year in question been "carrying on or doing business." Below we intend to closely scrutinize the record and the exhibits, and demonstrate the soundness of our contention.

We believe we shall show by the four corners of the record, that:

1. The record shows a clearly defined intention by Petitioner to liquidate its assets as rapidly as conditions reasonably warranted.
2. Such activities as Petitioner engaged in, during the capital stock tax year in question, were not carried on in furtherance of the purposes for which it was incorporated, but rather were reasonably related to (a) the maintenance and preservation of its properties and assets, and (b) the orderly disposal and liquidation of its properties and assets; and
3. The isolated transactions during the taxable year in which Petitioner granted an option or lease for oil exploration purposes did not indicate the seeking of a new source of prolonged business, but rather merely an attempt to create an additional value to the assets which it had for some time past been seeking to liquidate.

1.

The Record Shows a Clearly Defined Intention by Petitioner to Liquidate Its Assets as Rapidly as Conditions Reasonably Warranted.

The Petitioner's Articles of Incorporation specify as its purposes the following:

"SECOND—That the purposes for which it is formed are to buy and sell land and water, to subdivide land into farm or town lots and sell same, to develop water for domestic or irrigating purposes and sell same, to form stock corporations for the development, use and sale of water, to buy stock of any corporation where water can be obtained for the use of land and to do a

general land and water business in buying and selling same, to incur bonded or other indebtedness, to execute Deeds, Mortgages, Powers of Attorney or other instruments, to facilitate the purchase and sale of land and water, all of which business is to be done for profit.”

The Petitioner was active in the development of its land from incorporation until 1919 [Tr. p. 56] and its operations were most profitable, having paid dividends to 1923 of over \$3,000,000. [Petitioner's Exhibit No. 7.] In 1923, the Petitioner had about 200 acres scattered in several places. [Tr. pp. 56-57.] These properties were part of Petitioner's original holdings and their sale was slow. The business for which the Petitioner was organized had been abandoned [Tr. p. 79] and has never been revived, as is proved by the following recitals from the record:

1. The first recorded evidence of intention to liquidate occurred on April 17, 1919, when the Petitioner's Board of Directors adopted the following resolution:

“It was moved by Mr. Sartori, seconded by Mr. Torrance that Mr. Brand, Mr. Torrance and Mr. Chandler be appointed a committee for the purpose of devising and submitting a plan of segregating or distributing all of the remaining lands of this Company and submit a proposition to the Board of Directors.” [Petitioner's Exhibit No. 14.]

There is no record that the appointed committee ever acted under this authorization.

2. The fact that the corporation formally reduced its capitalization in 1921 from \$1,000,000 to \$100,000, is an

overt act in the direction of liquidation. At a directors' meeting on December 10, 1919, the following resolution was adopted:

"It was moved by Mr. Sartori, seconded by Mr. Marshall that the Company take steps to reduce the capital stock from One Million Dollars to One Hundred Thousand." [Petitioner's Exhibit No. 17.]

More than a year later, on January 24, 1921, a formal Certificate of Diminution of the Petitioner's capital stock in conformity with the above was duly filed. [Petitioner's Exhibit No. 4.]

3. The long-existing intention of Petitioner to liquidate was brought out by the introduction of correspondence between stockholders of the corporation and the Petitioner over a period of years from 1933 to 1937, as follows:

The Petitioner received an inquiry as to its status from the Trust Department of the Security-First National Bank of Los Angeles, dated January 21, 1933 [Petitioner's Exhibit No. 39], in which the Petitioner was asked—

"If it is possible for you to do so, we should appreciate a copy of the statement of the Company for December 31, 1932, although we realize that little progress has probably been made in liquidating the Company since the statement of December 31, 1930, which you furnished us. May we have your comments as to the present status of this Company?"

In response to this letter, Petitioner replied on March 16, 1933, in part, as follows [Petitioner's Exhibit No. 39]:

"The Company has made absolutely no progress in its efforts to liquidate and there is little hope of disposing of its holdings under present conditions."

The Petitioner also received a letter from the above stockholder on February 9, 1934, again asking the question "Can you inform us as to how successful the company has been during the past year in conducting the liquidation of its assets?", to which Petitioner on February 16, 1934, replied, in part, as follows [Petitioner's Exhibit No. 40]:

"We have made absolutely no progress in the liquidation of the assets of this Company, which remain the same as they were a year ago. Receipts from sale of oranges have not even paid current running expenses, and as a result, no taxes have been paid."

On June 8, 1934, Petitioner replied to an inquiry dated June 1, 1934, of the Wells Fargo Bank & Union Trust Co., San Francisco, a stockholder, as to the status of the Petitioner, in part as follows [Petitioner's Exhibit No. 41]:

"As you will see, practically the only assets of this corporation are the unplotted hill lands of approximately 138 acres and a 40 acre orange grove planted to navels. The only activity of the company is operation of the orange grove, and you will see from the statement the income does not even approximate the expenses. We are using our best endeavors to liquidate the company entirely."

On July 10, 1935, the Petitioner received a letter from Wm. G. Kerkhoff Company, a stockholder, requesting "any information you may have available in connection with its (Petitioner's) affairs," to which Petitioner re-

plied, on July 13, 1935, in part, as follows [Petitioner's Exhibit No. 42]:

“Up to the time of Mr. Jeffries' death, he tried very hard to dispose of the company as a whole; he also tried to sell the orange grove, the hill lands and the oil rights separately, but without success.”

Later in the same year, November 14, 1935, Petitioner replied to the Security-First National Bank of Los Angeles, Trust Department, which had inquired of Petitioner if the shares of Petitioner's capital stock it held could be sold, in part, as follows [Petitioner's Exhibit No. 43]:

“We regret to inform you that we know of no market at this time for the stock. We have tried for many years to liquidate the final holdings of this company but without success. In the event, however, that we learn of any one who would be interested in purchasing this stock we will get in touch with you.”

On November 22, 1937, Petitioner replied to the Security-First National Bank of Los Angeles in answer to its letter of October 22, 1937, in which was asked “Has there been any change in the possibility of the Company's liquidating its assets in the near future?”, in part, as follows:

“You inquire as to the possibility of the company liquidating its assets in the near future. We feel that this will develop into a long drawn-out process. The main assets of the company are the unsubdivided lands and oil reservations of unknown value.” [Petitioner's Exhibit No. 46.]

4. The long-existing intention of the Petitioner to liquidate was further brought out by the following statements attached to General Corporate Franchise Tax Returns to the State of California:

For the year 1926 [Petitioner's Exhibit 47]: "The affairs of this company are being wound up and is practically liquidated."

For the year 1927 [Petitioner's Exhibit 48]: "The affairs of this company are being liquidated and is practically liquidated."

For the year 1928 [Petitioner's Exhibit 49]: "This company is practically liquidated."

Between 1928 and the taxable year in question, the form of the California Franchise Tax Returns was changed so that it no longer was required to state the nature of the corporation's activities.

5. The testimony of R. F. Ingold, president of Petitioner since 1936, shows that he assumed office for the purpose of satisfying the Petitioner's debts and then dissolving the Petitioner as rapidly as possible after disposal of its assets. [Tr. pp. 93-94.]

6. Reference to Petitioner's Exhibits 36, 37 and 51, being respectively the Balance Sheets of the Petitioner on December 31, 1930, July 1, 1937, and June 30, 1938, indicate that the Petitioner had only three assets to be liquidated and that these assets were practically the same on all three dates, namely, a delapidated orange grove, unsalable hill lands, and mineral reservations to 3,000 acres of no established value. For purposes of proof, it was deemed unnecessary to carry the analysis of the

Petitioner's accounts back for more than 6½ years prior to the taxable year in question, but the record shows that the assets on the above dates were also the only assets of the Petitioner as far back as 1923. [Tr. pp. 56-57.] The above assets were unsalable and their disposal was a long and slow process. In support of this, is the following from the record:

a. The testimony of Walter R. Hilker, assistant secretary and director of the Petitioner and connected with Petitioner since 1925, on transcript page 57 stated—

“Nothing definite was done looking toward the sale of that land between 1919 down to the beginning of the fiscal year that ended on June 30, 1938. By that I mean people in the Valley around the packing house, etc., knew the property was for sale and would have been sold if a purchaser could have been found for it.”

On transcript page 59, Walter R. Hilker testified as to the orange grove—

“This grove is a part of the original 16,000 acres of land of the corporation. It wasn't sold with the other land that had been sold down to 1919 because it was just the tail-end piece of the whole property. Nobody bought it. It was for sale during that period. As to why the corporation continued to maintain the grove, I can only speak from the time I was there, 1925. It was a grove that was taken over with the other assets of the corporation at that time, and we just didn't know what else to do with it. We spent a minimum of money on it to keep it up until we could sell the property. It was for sale during all of that time.”

On transcript page 60, Walter H. Hilker testified as to the unplatted hill lands—

“That was the tail-end of the property owned by the corporation. It had never been platted into city lots or anything. It is just an unplatted tract of land. I have seen it many times. There are no improvements on it; there is no water available to it and no utilities available and no streets. It is remote from any of the established residential sections. I would say that that particular piece of land is about 18 or 20 miles from the center of Los Angeles. This property was a part of the original 16,000 acres of the corporation. It wasn't sold because they never found a buyer for it.”

Testimony showed that the oil reservations had no realizable or known value at any time, since they were on unproven oil lands, and are analyzed in greater detail *post*, page 61.

b. Correspondence introduced between the Petitioner and its stockholders also reflected the unsalable nature of the Petitioner's properties and holdings:

Reply to Wm. G. Kerkhoff Co., dated July 13, 1935
[Petitioner's Exhibit No. 42]—

“You will notice from these statements that the company is not in particularly good financial condition. Its assets consist mainly of a forty acre orange grove planted to navels; some 140 acres of unplotted rolling lands of nominal value and oil right on parts of the Sunshine Ranch, and various other little pieces of land which oil reservations are of unknown value.”

Reply to Wells Fargo Bank & Union Trust Co., dated June 9, 1936 [Petitioner's Exhibit No. 44]—

“As to the value of the stock, your guess is as good as ours. You will note that the company is in the unfortunate position where it cannot take care of its real estate taxes, and there just isn't sufficient income to properly take care of the orange grove. . . .

The only other assets belonging to the San Fernando Mission Land Company are 140 acres of unsubdivided rolling hill lands, which the company no doubt would be glad to sell for \$200 per acre, but cannot even get a bid for \$100 an acre. It also holds oil reservations on a great part of what is known as the Sunshine Ranch. Whether these oil reservations are worth anything is very problematical.”

7. The Petitioner had lapsed into a state of dormancy for many years which was evidenced by the following:

a. “. . . the date of the last meeting of directors of the corporation prior to the year 1936, was held on February 2, 1927.” [Tr. p. 68.]

b. “The last meeting of shareholders prior to the year 1936, was held on May 28, 1918.” [Tr. p. 68.]

“There were no activities at all between the stockholders of the corporation and the corporation during that interval, that is to say, the interval between the holding of the meeting of the directors in 1927 and the time at which a meeting was held in 1936. There was very little interest shown by any of the stockholders in the affairs of the corporation between those dates.” [Tr. pp. 68-69.]

c. “There were no meetings of any executive committee of the directors in that interval between the 2nd

of February, 1927, and the time in 1936 when the board proper next met." [Tr. p. 68.]

d. No dividends to stockholders were paid between 1923 and June 30, 1938. [Tr. p. 53.]

e. On September 14, 1936, four of the seven directors of Petitioner had died and not been replaced. Vice-President Sartori had forgotten he held office. Petitioner's president had died and not been replaced. [Tr. pp. 91 and 92.]

8. The Petitioner bought no new land, at any time after 1905. [Tr. pp. 79-80.]

9. The Petitioner was not formally liquidated and dissolved for the following reasons, as summarized by the testimony of W. R. Hilker [Tr. p. 80]:

"The assets were not distributed and the corporation liquidated prior to the close of the fiscal year ending on June 30, 1938, because it wasn't feasible to split up the land and distribute it to the stockholders. Neither was it possible under conditions that we had to sell the property. We couldn't sell the property and distribute the cash. The property was for sale during all of that time. Conditions were much different than the circumstances of the problems involved in a land dividend than the time the corporation paid out a million dollars many years ago. It is my opinion that it would not have been feasible to have distributed the land among the shareholders, that is, the unplotted hill land and the orange grove land."

In summary, it should be clear from this detailed recital that the Petitioner, as originally constituted, was organized for the purpose of engaging in the usual activities of a

subdividing company, created for the purpose of dealing in real estate and water rights at a profit. It carried on extensive business for many years, but it had sold practically all of its properties many years before July 1, 1937, and for many years it had been dormant and it had expressed its intent to liquidate its remaining assets to its shareholders. All of its original purposes therefore had been abandoned and there remained only the tedious task of selling its remaining properties as soon as it could reasonably be done in view of market conditions. Whatever activities it engaged in were obviously not for profit, but incidental to liquidation.

2.

Such Activities as Petitioner Engaged in, During the Capital Stock Tax Year in Question, Were Not Carried on in Furtherance of the Purposes for Which It Was Incorporated, but Rather Were Reasonably Related to (a) the Maintenance and Preservation of Its Properties and Assets, and (b) the Orderly Disposal and Liquidation of Its Properties and Assets.

Petitioner's Exhibit No. 38 and Item 19 under Section IV herein, *ante*, page 13, fully disclose all transactions of the Petitioner for some 6½ years prior to the taxable year in question. The Petitioner's business transactions during this period have been submitted in order to clearly establish the fact that long before the year in question every activity of Petitioner was directed to the sole end of liquidation or maintenance of the corporation's assets and properties.

The extended period required by Petitioner to liquidate its few holdings may be more readily understood when it

is recalled that these assets were unsalable, the Petitioner's operations were unprofitable, and, as a result, no one connected with Petitioner took sufficient interest to vigorously effect its liquidation.

During the six and one-half years prior to July 1, 1937, the Petitioner's activities consisted of the following—

1. It operated an orange and lemon grove not for profit but simply because the management was not able to dispose of it.

The grove had been operated at a continual and substantial loss during the entire period. It was unsalable. It was in bad condition for many years prior to 1930 but after this period its condition became worse and the Petitioner had neither the desire nor the means to invest in rehabilitating it. The question of what to do with the grove had confronted the Petitioner for many years and it has been clearly established that the only reason Petitioner retained the grove was that it hesitated to abandon it as a total loss before being forced to do so.

2. It sold one small parcel of less than 2 acres of its land in 1932, which was in pursuance of its intent to liquidate.

This was the only sale of land by Petitioner in the whole six and one-half years.

3. It sold its retained mineral interest in a small parcel of its holdings in 1936, to the surface owner of the land, which was in pursuance of its intent to liquidate.

This was the only sale of mineral interests made by Petitioner in the entire six and one-half year period.

4. It received \$10.00 in 1931 for a quit-claim deed to clear title on a previous transaction, and it received \$75.00 in 1935, for use of its hill land for pasture purposes, these transactions being so incidental and insignificant that they may be disregarded.

5. It paid or incurred property taxes, franchise taxes, interest on money borrowed, and nominal administration expenses during the period, but all were nominal in amount and related solely to the maintenance of its assets.

In the taxable year in question, being the period from July 1, 1937, to June 30, 1938, the activities of Petitioner were of the same nature as these recited in the 6½ years previous and they were all directed to the same end of liquidation or maintenance of the Petitioner's assets and properties. During this year, the Petitioner's activities consisted of the following (*ante*, page 18 herein and Petitioner's Exhibit No. 50):

1. It sold a small parcel of 4.75 acres of its remaining unplotted and unimproved hill land, which was in pursuance of its intent to liquidate.

2. It sold a mineral reservation interest in a single piece of property to the surface owner of the land, which, again, was in pursuance of its intent to liquidate.

3. It received final proceeds from its orange groves, which was abandoned during the year, some pasture rental, and other small items which did not amount to \$200.00, and which were incidental to its ownership of the property.

4. It incurred expenses in upkeep of the grove until abandoned and for certain expenses incident to pulling

out the trees upon abandonment of the grove, but these activities were involved not in an operation for profit but, on the contrary, strictly in liquidation of the Petitioner's investment in the grove.

5. It paid or incurred expenses for property taxes, franchise taxes, and sundry items, all being nominal in amount and related solely to the maintenance of its assets.

6. It loaned the Angeles Mesa Land Co., a 10% stockholder, the sum of \$1,500.00 on open account, without interest, purely as an accommodation. This transaction was obviously entered into without expectation of profit and, as such, is not a transaction coming within the concept of "carrying on or doing business."

Rose v. Nunnally Inv. Co., 22 F. (2d) 102;

Automatic Fire Alarm Co. of Del. v. Bowers, *supra*.

7. It entered into an oil and gas lease on part of its mineral reservation interests. This entire subject of the true nature of Petitioner's mineral reservation interests is fully analyzed on *post*, pages 61 to 72, but for present purposes, it is respectfully submitted that this one lease, in and of itself, is a transaction which is properly in harmony with Petitioner's position that it was not doing business but that its activities were incidental to liquidation.

In summary, therefore, it is respectfully submitted that the Petitioner's activities and situation in its entirety in the taxable year in question and for many years prior thereto, were all in pursuance of its intent to liquidate or maintain its assets and properties and that nothing arose to change this clear course at any time prior to June 30, 1938.

3.

The Isolated Transactions During the Taxable Year in Which Petitioner Granted an Option or Lease for Oil Exploration Purposes Did Not Indicate the Seeking of a New Source of Prolonged Business, but Rather Merely an Attempt to Obtain an Additional Value to the Assets Which It Had for Some Time Past Been Seeking to Liquidate.

In his "Findings of Fact" [Tr. p. 14]; and in his "Opinion" [Tr. p. 17] Board Member Sternhagen refers here and there to the reservation by Petitioner of mineral rights to approximately 3,000 acres of its original 16,000 acre holdings and to occasional transactions involving leasing for oil explorations. In his Opinion particularly, the following statement is made:

"That it was ready to do whatever business came its way and make whatever current profit was available is shown by the evidence of substantial transactions later in 1938 involving oil leases for long terms. This activity was not a departure from earlier plans and practices; similar attempts were made in the tax year. At the meeting of September 14, 1936, it considered leasing its oil rights and thereafter actively sought to do so." [Tr. pp. 18, 19.]

It is Petitioner's position that the Board Member has given unwarranted emphasis to sporadic transactions which were clearly incidental to a landowner's attempts to liquidate its assets. Psychologically, it is evident why the overemphasis has been made. In the latter part of 1938, Petitioner executed two leases of its mineral oil rights covering certain acreages, for substantial bonuses. Applying the "hindsight rule" which is certainly a human

frailty, the Board Member has in his mind's eye magnified every isolated transaction which may happen to relate to oil exploration on Petitioner's land, and piecing together these transactions which have occurred over a period of twenty years, he makes the entirely unwarranted inference that Petitioner has actively engaged in the business of oil exploration.

We intend to show by close examination of the record, including the oral testimony, the minutes of stockholders' and directors' meetings, and correspondence, that whatever transactions Petitioner may have engaged in relating to oil activities were entirely and always consistent with its declared purposes to liquidate its properties; that at no time did Petitioner engage in oil exploration as such; that the lucrative leases executed by Petitioner after June 30, 1938, clearly constituted a "windfall."

Now, let us look at the record:

1. All the mineral reservation interests of Petitioner arose out of a single transaction in 1919, and the reservation was merely incidental to this transaction and not a new course of business for Petitioner.

(a) On May 23, 1919, Petitioner sold all its remaining land of approximately 3,000 acres, excepting the two parcels still owned in the tax year in question, to The Sunshine Company; the sales price of this bulk sale was so low that the mineral interests were retained. [Tr. pp. 98 and 56.]

(b) Since these reserved mineral interests were on land which the Petitioner acquired upon its incorporation [Tr. p. 62], this transaction, therefore, was not a new investment by Petitioner but merely a change in the form of Petitioner's ownership.

2. In the course of the subsequent 20 years from 1919 to June 30, 1938, Petitioner never considered the mineral reservations of any value.

(a) Between 1919 and 1936, the mineral reservations were not even reflected on Petitioner's books as an asset. [Tr. p. 63.]

(b) In 1936, Petitioner's bookkeeper set the mineral interests on the books at a nominal value of \$1.00, merely to place something on the books which would recognize the possible existence of the rights. [Tr. p. 87.]

(c) The testimony of Walter R. Hilker established the fact that at no time prior to June 30, 1938, did the Petitioner consider the oil reservations as having any value. [Tr. pp. 81 and 88.]

(d) The testimony of Reuben F. Ingold also established the fact that Petitioner did not believe that the mineral reservations had any value even in 1936. [Tr. p. 98.]

(e) Correspondence, between 1933 and 1937, with stockholders, who were inquiring as to the Petitioner's financial condition and its progress towards liquidation, seldom even mentioned the mineral reservations as being assets of the Petitioner and when mention was made, the interests were described as being of unknown or problematical value only.

Petitioner's Exhibit No. 41, dated June 8, 1934, describes the corporation's assets on December 31, 1933, as follows:

"As you will see, practically the only assets of this corporation are the unplotted hill lands of approximately 138 acres and a 40 acre orange grove planted to navels."

Petitioner's Exhibit No. 42, dated July 13, 1935, describes Petitioner's assets on December 31, 1934, as follows:

"Its assets consist mainly of a forty acre orange grove planted to navels; some 140 acres of unplotted rolling lands of nominal value and oil rights on parts of the Sunshine Ranch, and various other little pieces of land which oil reservations are of unknown value."

Petitioner's Exhibit No. 44, dated June 9, 1936, describes the oil reservations as follows:

"It also holds oil reservations on a great part of what is known as the Sunshine Ranch. Whether these oil reservations are worth anything is very problematical."

Petitioner's Exhibit No. 46, dated November 22, 1937, states:

"The main assets of the company are the unsubdivided lands and oil reservations of unknown value."

(f) Petitioner was never acquainted with, nor did it ever have a survey or study made by experts to determine whether there was a probability or likelihood of there being oil or minerals upon any of Petitioner's interests. [Tr. pp. 89 and 103-104.]

(g) There has been no oil production whatever on Petitioner's land at any time. [Tr. pp. 89 and 105.]

(h) As has been shown in the record, the Petitioner was dormant for many years, during which time it had no activity of any kind, let alone any activity with respect to its oil reservations. [Tr. pp. 68-69.]

3. In the course of the subsequent 20 years from 1919 to June 30, 1938, the few transactions which Peti-

tioner had with respect to these mineral interests were in furtherance of its long-existing intent to liquidate and not in carrying on an oil leasing business.

a. A full recital of every transaction with respect to its oil reservations between 1917, the first time any reference was made to its oil interests, and June 30, 1937, the beginning of the taxable year in question, indicates that in this 20 year period, Petitioner had only incidental and occasional transactions, that all such transactions were small in amount, and that these transactions were the normal opportunities of any owner of property rather than the acts of a corporation in the oil leasing business.

1. Between the years 1917 and 1919 the transactions which might be considered relating to oil rights were so minor and inconsequential that we do not take the space necessary to recite them. [Petitioner's Exhibits 10, 11, 14.] However, in 1919, as we have indicated above in connection with the sale to The Sunshine Company, the Petitioner did reserve mineral rights to the approximate 3,000 acres then disposed of. This sale in fee disposed of practically all of Petitioner's real estate except the two parcels which it retained up to the tax year in question.

2. Between 1919 and 1925, Petitioner had no transactions in its mineral interests.

3. In 1925 [Respondent's Exhibit "H"] Petitioner considered two oil lease proposals but rejected both and no further action was taken. Rejection of an offer to lease is consistent with the right of Petitioner to obtain a good price for its assets and such refusal does not alter an intent to liquidate. A liquidating concern may put forth its best efforts to realize

the greatest sum for its assets without thereby converting its liquidating activities into that of "carrying on or doing business."

The Union Land & Timber Co. v. United States, supra.

4. In 1927 [Petitioner's Exhibit 6] Petitioner took the following action in connection with its mineral reservations:

It accepted the sum of \$2,940.00 for granting quit-claim deeds to mineral interests it had reserved when the land was previously sold. As recited in the minutes, Petitioner had promised to release the mineral interests at the time of sale, and this action was taken in conformity with such promise and not as a separate transaction.

It received two oil lease offers, rejected one and accepted the other providing for a bonus on execution and royalty on oil. No oil was ever discovered, no royalty ever received, and the lapse of some 10 years between this date and the taxable year in question would certainly indicate that this transaction did not ripen into a sufficiently important aspect of Petitioner's business to constitute a new source of profit.

It voted not to authorize the execution of any more oil releases by the Petitioner "for the present, at least."

This was a minor transaction, as evidenced by the fact that Walter R. Hilker who was present at said meeting did not recall the reason for such action [Tr. p. 81].

It would appear obvious however, that this action is completely inconsistent with any interpretation that Petitioner had entered the oil leasing business. If it were in the oil leasing business, it certainly would not

logically decide to discontinue making leases; on the contrary, it would certainly have aggressively sought such leases.

It refused to quit-claim its reserved mineral rights which were retained on The Sunshine Company transaction to the later surface owners (The California Trust Co.). No consideration was mentioned in the minutes and none was offered. This action clearly indicates that the considered worth of the mineral interests at that time was zero. And as to the Petitioner, its refusal to release its reservations for no consideration is certainly understandable. An intent to liquidate does not require blind acceptance of every opportunity to dispose of its assets, on the contrary, it may endeavor to obtain the best possible price for its properties at all times.

5. For almost 10 years, from 1927 to September 14, 1936, Petitioner held no directors or executive committee meetings, and no oil reservation transactions were had. [Tr. pp. 68 and 69.]

6. On September 14, 1936, a directors' meeting was held [Petitioner's Exhibit No. 2] in which the following transactions relating to Petitioner's oil reservations were had:

It sold for \$7,500.00 its reserved mineral rights in and to approximately 233 acres to the Associated Oil Company, the owner of the surface land. This transaction is consistent with Petitioner's intent to liquidate since by this sale, Petitioner retained no further ownership in the interests and such a transaction resulted in reducing its assets to cash.

It refused to enter into an oil and gas lease with the Progressive Syndicate which provided for no lease bonus. As previously stated, a refusal to accept an

offer is not in itself inconsistent with an intent to liquidate. Further, the opportunity to make a lease for no bonus is not proof of value, particularly when this was the one and only offer since 1927.

It refused to release its mineral interests to the California Trust Company, the surface land owners. As stated in the Record [Tr. p. 98] no consideration was offered for this release but the Petitioner felt that since the original sale was at a very low price and that if the reservations were to be released, the Petitioner should be paid therefor. There was no thought of value to the interests in this decision by Petitioner.

b. During the taxable year in question, Petitioner had only the following transactions relating to its mineral reservations:

It sold to John O'Melveny, the surface owner, its reserved mineral interest in land that he owned, for a total consideration of \$1,180.00. As previously discussed, this sale of Petitioner's interest was in direct furtherance of Petitioner's plan to liquidate, it retaining no further interest in this property.

It authorized a lease to one Wm. McClintock on November 10, 1937 [Petitioner's Exhibit No. 24] but this lease was never consummated. No bonus or other consideration was received for this lease and, in order to avoid clouding Petitioner's title, it was placed in an escrow pending actual starting to drill on the property. Lessee never started to drill and at the end of 3 months, as provided, the escrow was cancelled and the lease was never delivered to the lessee. Thus, the transaction was never consummated and, as far as the Petitioner is concerned, was never in effect. The precautions taken

by Petitioner to insure performance by the lessee were merely good business judgment, particularly so when there was no requirement on the part of the lessee to make any immediate investment in the lease. There is no requirement, under the law, that liquidating companies use less caution in their transactions than any others, or forfeit their intent to liquidate if they do so.

It entered into an oil and gas lease on part of its mineral reservation holdings with one A. Llewellyn Howell on March 16, 1938 [Petitioner's Exhibits 25 and 28]. No bonus or consideration was received and rental was to be paid after six months in the event he did not start to drill. Lessee did not start to drill prior to June 30, 1938 [Tr. p. 100]. The Howell lease was merely an option since Howell paid nothing for the lease and the only recourse of Petitioner in the event that Howell failed to drill or pay rental if he so failed to drill, was to cancel the lease. This lease was purely speculative and the circumstances under which this lease was made were no different than those which existed for many years previously. As stated at Tr. page 114, Petitioner had an opportunity to lease the property on the basis of rentals for six months. It had not changed the Petitioner's purpose of liquidating as rapidly as possible. The Petitioner still planned to sell whatever assets it had. If drilling operations were successful, Petitioner could then have determined a value on the oil rights or it could have distributed them to the shareholders.

In *Lyon Lumber Co. v. Harrison* [113 F. (2d) 443], plaintiff had executed an option for an oil lease, among other activities, and defendant contended that this constituted an act of "doing business." The Circuit Court stated that such an activity was in harmony with plaintiff's

claim that it was not doing business and that if that was all plaintiff did, the execution of an option for an oil lease was not in and of itself an act of "doing business." In the instant case, this lease was the only act of Petitioner in connection with leasing of its mineral interests and, under the above circumstances, is not in and of itself an act of doing business.

Finally, the advantage to Petitioner in establishing a value to its long held and unknown mineral interests in furtherance of its intention to liquidate appears obvious. Any distribution of its mineral interests as long as they were of unknown or speculative value would merely have served to have hopelessly clouded the title to said interests. With many persons owning undivided interests, any opportunity of leasing such interests would have been impossible. On the other hand, had a value been created, then distribution could have been made without any complications. The only recourse of Petitioner was to hold such interests until their disposal or until a real value had been created by finding oil.

The above recital represents every transaction, whether consummated or not, by Petitioner with respect to its mineral interests from 1917 to June 30, 1938. We can find nothing in such record reflecting anything other than incidental transactions which arose simply by virtue of Petitioner's ownership in the mineral interests. The sales of mineral interests were in direct furtherance of Petitioner's intended liquidation just the same as the sale of any of its other assets. Petitioner had but two oil leasing transactions in the entire 21 year period—one in 1927 in which oil was never found and which was followed by

a period of almost 10 years of complete dormancy of the Petitioner, and the other in 1938, which was merely an option on a speculative basis. It is respectfully submitted that the two lease transactions cannot be so magnified in importance, either by themselves or in view of the expressed intent of the Petitioner to liquidate, so as to convert Petitioner's activities into those of an oil leasing company.

4. The leases on which Petitioner received bonuses in 1938 arose in their entirety after the taxable year in question and were not the result of any prior plan of Petitioner, but were purely "windfalls."

(a) The Tidewater-Associated lease was executed on August 26, 1938, providing for a \$20,000 bonus, and the Shell lease was executed on November 25, 1938, providing for a \$76,130.00 bonus. [Tr. pp. 104-105 and Petitioner's Exhibits No. 29, 30.]

(b) The testimony of both Ingold and Hilker indicate that Petitioner did not seek out the Tidewater-Associated Oil Company but rather that Petitioner was approached by representatives of said company on August 19, 1938, and negotiations were then started resulting in the lease dated August 26, 1938. [Tr. pp. 103 and 115.]

(c) After the execution of the Tidewater-Associated lease, and on the basis of this lease, the Petitioner retained Robert V. New to solicit an oil lease on other property owned by Petitioner, resulting in the Shell lease of November 25, 1938. [Tr. pp. 106-107.]

(d) Petitioner had no knowledge of any leasing activity in the vicinity or of any oil interest at any time prior to August 19, 1938. [Tr. pp. 105, 113 and 115.]

(e) No oil has been found on the properties leased. [Tr. pp. 105 and 109.]

(f) The act of Petitioner in fixing a zero value on its 1938 Capital Stock Tax Return which was filed in the latter part of July, 1938, is further evidence that Petitioner was not aware of the making of the above leases at that time. [Tr. p. 112.]

VI.

Conclusion.

While we stand humble before the burden which is placed upon Petitioner in face of the adverse ruling of the Board of Tax Appeals, yet we are strong in the belief that we have fairly and substantially sustained that burden.

The Board Member, we are satisfied, would not have decided adversely to Petitioner had not the Supreme Court handed down its opinion in the *Magruder* case, thus seemingly affording him a ready-made answer to his problem. Had more care been exercised in his analysis, we are satisfied the Board Member would have been convinced, too, that the *Magruder* decision had no applicability to the facts of our case.

Fairly and properly appraised—and not swayed by the glow of an unforeseen bonanza which fell into Petitioner's lap after the taxable year in question—it should be plain that (1) Petitioner has for a good many years concentrated its efforts on the liquidation of all of its assets; (2) that in the taxable year in question Petitioner was left holding only a few of its unsalable assets, and was not engaged in any activities for the end of profit other than

were incidental to the maintenance, conservation, or disposal of its remaining assets, and (3) that its occasional and sporadic transactions apart from the leasing of its reserved oil rights cannot by any reasonable interpretation be considered as a new venture for profit, but constituted a perfectly normal attempt by a liquidating company to set a measure of value on its remaining assets, including the reserved mineral rights.

Considered as a whole, in the light of the rules which the courts have laid down as guides, it is our position that Petitioner was not, from July 1, 1937, to June 30, 1938, "carrying on or doing business" within the meaning of the applicable statutes and regulations.

For these reasons, the Judgment of the Board of Tax Appeals should be reversed.

Respectfully submitted,

HARRY GRAHAM BALTER,
Attorney for Petitioner



No. 10272

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

SAN FERNANDO MISSION LAND COMPANY, A CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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FILED

JUL 1 1947

PAUL P. O'BRIEN,
CLERK



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In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10272

SAN FERNANDO MISSION LAND COMPANY, A CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED
STATES BOARD OF TAX APPEALS*

BRIEF FOR THE RESPONDENT

OPINION BELOW

The only previous opinion in this case is the memorandum opinion of the United States Board of Tax Appeals (R. 14-19), which is not reported.

JURISDICTION

The petition for review herein involves a deficiency in excess profits tax liability in the sum of \$8,035.64¹

¹ The case before the Board of Tax appeals involved deficiencies in both income and excess profits tax liabilities in the respective amounts of \$4,508.56 and \$8,035.64 for the taxable year 1938. (R. 14.) Two other issues (involving commissions and attorney's fees paid by the taxpayer) were decided adversely to the taxpayer by the Board (R. 19) and are now conceded and have been abandoned by the taxpayer (Br. 2). There remains therefore the single issue presented herein, stated hereinafter, involving a deficiency

asserted against the taxpayer for the taxable year 1938 by the Commissioner of Internal Revenue in notice of deficiency mailed February 8, 1941. (R. 8-12, 14.) Within ninety days thereafter and on May 5, 1941, the taxpayer filed a petition with the Board of Tax Appeals for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 4-12.) The final order and decision of the Board of Tax Appeals sustaining the deficiency, was entered on May 25, 1942 (R. 20), the taxpayer's motion for revision and review filed June 18, 1942 (R. 21-31) having been denied by the Board on June 19, 1942 (R. 32). The case is brought to this Court by petition for review filed July 24, 1942 (R. 33-42), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the taxpayer was "carrying on or doing business" during any part of the capital stock tax year ended June 30, 1938, within the meaning of Section 601 (a) of the Revenue Act of 1938, so that it is subject to an excess profits tax liability for the calendar year 1938 imposed by Section 602 (a) of that Act.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 23-27.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 14-17) are as follows:

in excess profits tax in the sum of \$8,035.64 for the taxable year 1938. (Br. 2.)

Taxpayer is a California corporation with principal office at Los Angeles, California, and filed its 1938 income tax return with the Collector there. It was organized in 1904 to buy, develop, and sell land; it acquired over 16,000 acres about fifteen miles from the center of Los Angeles, and engaged actively and successfully in the development and sale of this tract. In 1918 it declared a dividend of \$1,000,000 which it paid by a distribution of lands among its shareholders. Thereafter it donated some land to the city for parks, restricted its business activity, reduced its capitalization from \$1,000,000 to \$100,000, and distributed \$1,250,000 in a series of dividends, the last being one of \$100,000 paid on January 29, 1923. Few assets remained, and shareholders displayed little interest in the corporation, but it was not dissolved. After a meeting on February 2, 1927, the directors did not again meet for nearly a decade. On state franchise tax returns, taxpayer was described as "practically liquidated."

Taxpayer's remaining properties after 1930 consisted of a thirty-five acre grove of orange and lemon trees, 138 acres of unplotted hill lands, reservations of mineral rights in some 3,000 acres of land previously sold, and a very small amount of cash. The grove was in poor condition, unprofitably operated for many years, and in 1937 the trees were uprooted and it was abandoned to the state for unpaid taxes. The hill lands lying some twenty miles from the center of Los Angeles were without improvements or available water. Of the original acreage, they constituted a part for which no buyer was found. The grove and these lands were carried on taxpayer's books at \$52,500 and \$13,800, respectively. The

reservations of mineral rights were carried at one dollar. In selling its real estate, taxpayer had in some cases reserved mineral rights and as in early years had authorized its officers to execute oil and gas leases. The board of directors in 1925 gave consideration to proposals for oil leases, and at the meeting on February 2, 1927, they considered several proposals and ratified a release of the reserved rights in certain land for a consideration of \$2,940. At the same time they resolved to make no more such releases "for the present, at least."

After 1930, taxpayer operated the grove at a continual loss; in 1932 it made one sale of realty for about \$1,500; in 1935 it rented pasture for \$75, and in 1936 it received \$7,500 for release of oil reservations and for a lot. Taxes and expenses exceeded income except in 1936, and the balance sheet constantly showed a deficit of about \$40,000 during the period. In 1936 no oil had been found on or near taxpayer's properties and no survey for oil had been made. At the instigation of the president of one of taxpayer's creditors, the directors met on September 14, 1936, and elected him president. He entered into negotiations for the leasing of oil rights. A lease, authorized by the directors and placed in escrow on November 10, 1937, was not delivered because of the lessee's failure to perform conditions. On his initiative, the grove was abandoned in the fall of 1937.

During the fiscal year July 1, 1937-June 30, 1938, taxpayer received \$51.87 in the sale of fruit; \$50 from the rental of pasture; and two other small items. From

the sale of 4.75 acres of the hill lands it realized a profit of \$1,890 and in the sale of reserved oil rights it received \$1,180. Its total income was \$3,270.66, and its expenses and taxes were \$2,897.34. On March 16, 1938, taxpayer made a twenty-year lease of oil rights for royalties which are being paid. On August 26, 1938, it made a lease of oil rights for \$20,000 and royalties from oil as long as produced.

Taxpayer received income from its leases in 1938, 1939 and 1940, and declared dividends in each of those years.

In the fiscal year ending June 30, 1938, taxpayer was carrying on and doing business.

On August 26, 1938, taxpayer employed Robert V. New to promote and negotiate oil leases. His compensation was to be based on the amount of rental. Through New's efforts, taxpayer made a lease of oil rights on November 25, 1938, for a minimum period of twenty years, receiving \$76,130 and the right to a royalty. Pursuant to the employment agreement, taxpayer paid New \$33,306.88 for negotiating this lease and paid an attorney \$250 for preparing the instrument.

Upon the basis of the foregoing facts the Board held that the taxpayer corporation carried on or did business during the year ended June 30, 1938, and therefore it was properly subjected to the excess profits tax liability in question for the calendar year 1938. (R. 19.) The Board thereupon entered its decision accordingly (R. 20) from which the taxpayer petitioned this Court for review (R. 33).

SUMMARY OF ARGUMENT

Under the pertinent regulations, the taxpayer's activities during the fiscal year ended June 30, 1938, constituted carrying on and doing business within the meaning of the statute. The regulations, consistently applied administratively since 1918, have been held to be a reasonable and permissible construction of the act. The Board found as a fact and concluded that the taxpayer was carrying on and doing business during the critical period. Its findings are supported by substantial evidence. They should therefore be affirmed.

Selling, renting and managing real estate and making leases for cash and collecting royalties therefrom have been held to be doing business within the meaning of the statute. The taxpayer not only merely owned property and engaged in conduct incidental to the distribution of the avails but engaged in many other activities of a profitable business nature.

The fact that the taxpayer might have *intended* to liquidate its properties some time or other, does not mean that it was not engaged in business. Since it was engaged in activities ordinarily carried on for profit, it is immaterial whether it was making a profit or intended eventually to liquidate. In fact, however, the taxpayer was not only seeking a profit but actually made substantial profits in selling and leasing its lands and collecting profits and royalties, therefrom. It was therefore doing business and is liable for the tax in question.

ARGUMENT

The taxpayer was engaged in "carrying on or doing business" during the capital stock tax year ended June 30, 1938, within the meaning of Section 601 (a) of the Revenue Act of 1938, and therefore it is subject to excess profits tax liability for the calendar year 1938

As taxpayer properly states (Br. 9), if under the facts herein, it was "carrying on or doing business" for any part of the capital stock tax year from July 1, 1937, to June 30, 1938, then it was liable for the excess profits tax here in dispute on its net income for the calendar year 1938. Sections 601 (a) and 602 (a), Revenue Act of 1938, Appendix, *infra*; Articles 41-44, Treasury Regulations 64 (1938 Edition), Appendix, *infra*. The issue therefore is simply whether or not the taxpayer carried on any business activities during the fiscal year ended June 30, 1938. The taxpayer contends in substance that it did not carry on any such activities during the critical period for the reason that it did none of the things for which it was created but only whatever was reasonably necessary to maintain its corporate existence, conserve its properties and assets and dispose of them in liquidation. (Br. 23-47.) The Board, however, determined (R. 19) that the taxpayer was actually carrying on and doing business in that year and therefore it was liable for the tax in question (R. 17-19). We submit that the findings on which the Board based its conclusion are supported by substantial evidence and that in applying the law to the facts the Board committed no error.

(a) Under the statute and pertinent regulations and authorities, the taxpayer was carrying on and doing business during the critical period

The statute imposes the excess profits tax for any calendar year if the taxpayer carried on or did business for any part of the capital stock tax year ended the preceding June 30th. Sections 601 (a) and 602 (a), Revenue Act of 1938. The pertinent regulations provide that the tax is imposed upon the privilege of doing business and with respect to the taxpayer's carrying on or doing business, and not upon the business itself as carried on (Article 41, Treasury Regulations 64 (1938 Edition)); that regardless of the nature of the activities, a taxpayer organized for the purpose of profit and carrying out such purpose is doing business, just as it is if not organized for profit so long as it is engaged in activities ordinarily carried on for profit; that it is immaterial whether the activities result in profit or loss, successful or unsuccessful enterprise, or because of unfavorable business conditions no operations are carried on for a particular period, it being unnecessary that any particular amount of business be done or that it be continuous throughout the year; and that only in the most exceptional cases, such as where the corporation is not seeking profit, do the activities amount to its not doing business within the meaning of the act (*id.*, Article 42). As illustrations, the regulations provide that doing business includes such activities as the mere leasing and managing of properties and collecting the rents or royalties, or leasing them to another without divesting oneself of all control and management thereof; the orderly liquidation of property by making sales from time to time and distributing the proceeds therefrom; and any

other activities coming within the ordinary signification of carrying on or doing business. (*Id.*, Article 43 (a), paragraphs 3, 5, 7 and 8, Appendix, *infra.*) Where the corporate powers or its retirement from business limits or reduces the activities to the mere owning and holding of property and the distribution of it avails, the corporation is exempt from the tax, provided, however, that it does not engage in other activities or maintain its organization for the purpose of continued effort in the pursuit of profit or gain; and only where the corporation had no business activities during the entire taxable year because it became dormant or completed or abandoned its business, is it entirely free from the tax. (*Id.*, Article 43 (b), paragraphs 1 and 3, Appendix, *infra.*) These regulations have been sustained as valid. *Magruder v. Washington, B. & A. Realty Corp.*, 316 U. S. 69.

Substantially the same regulations as the foregoing have been in effect ever since 1918,² covering a long period in which the statute has been reenacted several times³ These regulations thus represent a contempo-

² Except for the period during which the tax itself was not in existence between 1926 and 1933, these regulations have remained substantially the same since the Revenue Act of 1918, c. 18, 40 Stat. 1057. Article 18, Treasury Regulations 50 (1919 Edition); Article 11, Treasury Regulations 50 (1920 Edition); Article 12, Treasury Regulations 64 (1922 Edition and 1924 Edition); Article 22, Treasury Regulations 64 (1933 Edition); Article 33, Treasury Regulations 64 (1934 Edition); Article 43, Treasury Regulations 64 (1936 Edition); Articles 41-43, Treasury Regulations 64 (1938 Edition).

³ Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 1000; Revenue Act of 1921, c. 136, 42 Stat. 227, Section 1000; Revenue Act of 1924, c. 234, 43 Stat. 253, Section 700; National Industrial

aneous and long-continued administrative interpretation of the statute and, accordingly, are entitled to great weight. *Brewster v. Gage*, 280 U. S. 327; *Fawcus Machine Co. v. United States*, 282 U. S. 375; *McCaughn v. Hershey Chocolate Co.*, 283 U. S. 488; *United States v. Shreveport Grain & El. Co.*, 287 U. S. 77; *Textile Mills Corp. v. Commissioner*, 314 U. S. 326. It is settled that, by clear implication, they have therefore been ratified by Congress and that doubt may not properly be raised as to their validity or the propriety of the departmental practice in applying them over so long a period of time. *White Motor Co. v. United States*, 3 F. Supp. 635 (C. Cls.), certiorari denied, 290 U. S. 672; *United States v. Safety Car Heating Co.*, 297 U. S. 88, rehearing denied, 297 U. S. 727. In *Magruder v. Washington, B. & A. Realty Corp.*, *supra*, the Supreme Court stated, in respect to the same regulations (Article 43 (a) (5), Treasury Regulations 64), the following (pp. 73-74):

Article 43 (a) (5) is both a contemporary and a long standing administrative interpretation, having been in effect in substantially the same form since 1918, except for the period from 1926 to 1933 when the tax was not imposed. We are of opinion that it is valid, as well as applicable. The crucial words of the statute, "carrying on

Recovery Act, c. 90, 48 Stat. 195, Section 215; Revenue Act of 1934, c. 277, 48 Stat. 680, Section 701; and the Revenue Acts imposing taxes for the fiscal years ended June 30th, as herein—Revenue Act of 1935, c. 829, 49 Stat. 1014, Section 105; Revenue Act of 1936, c. 690, 49 Stat. 1648, Section 401; and Revenue Act of 1938, c. 289, 52 Stat. 447, Section 601, the latter being identical, as now set forth in Internal Revenue Code, Section 1200.

or doing business'', are not so easy of application to varying facts that they leave no room for administrative interpretation or elucidation. To be sure, in many, if not in most instances, the factual situation will be so extreme as to leave no doubt whether a corporation is doing business or not. But the nuances of facts between the two extremes have produced a nebulous field of confusion which has been recognized by courts striving to fit close cases into one category or the other. Interpretative regulations, such as Article 43 (a) (5), are appropriate aids toward eliminating that confusion and uncertainty. Cf. *Helvering v. Wilshire Oil Co.*, 308 U. S. 90, 102; *Textile Mills Securities Corp. v. Commissioner*, 314 U. S. 326.

We submit that a consideration of the facts leads inevitably to the conclusion that the taxpayer was carrying on or doing business within the meaning of the statute. The decision is in accord with the regulation interpreting the statute and with the decisions.

Thus, the taxpayer was organized in 1904 to buy, develop and sell land and thereafter acquired more than 16,000 acres of land in connection with which it engaged actively and successfully in the development and sale thereof. (R. 14, 46-47, 51, 56 ⁴.) The portions of its properties remaining in its hands in the critical fiscal year ended June 30, 1938, constituted a 35-acre tract comprising an orange and lemon grove and 138 acres of unplotted hill lands carried on the taxpayer's books at \$52,500 and \$13,800, respectively, and reservations of

⁴ The record citations, after the Board's findings of fact (R. 14-17), refer to the evidence supporting the findings.

mineral rights in approximately 3,000 acres of lands,⁵ previously sold, carried on its books at \$1, the 35-acre tract having been abandoned during the fall of 1937 for unpaid state taxes. (R. 15, 58, 60, 62-63, 66, 76, 79, 81-82, 84, 87, 93, 98, 102, 112.) The taxpayer carried on slight business activities during 1930-1935, sold a lot, released oil reservations for \$7,500 and entered into negotiations for the leasing of oil rights in 1936. (R. 16, 47, 61, 64-65, 90, 95-96.) During the critical year ended June 30, 1938, however, the taxpayer authorized and placed in escrow a lease (which was not delivered because of the lessee's default), abandoned the above-mentioned grove, sold some fruit, rented pasture lands and had other small activities. Also during that year, it made a loan of \$1,500, sold a portion of the hill lands at a profit of \$1,890, received \$1,180 upon the sale of reserved oil rights, made a 20-year lease of oil rights for royalties which are still being paid to it, realized a total income of \$3,270.66, and had expenses and taxes in the aggregate amount of \$2,897.34. (R. 16, 71-79, 81-82, 88, 89, 90, 94, 100-101.) After June 30th, but still within the taxable year 1938, the taxpayer continued to pursue its same business activities, having made a lease of oil rights for \$20,000 plus royalties from the oil therefrom as long as produced, made a lease for a minimum period of 20 years for \$76,130 and the right to royalties therefrom, having paid its agent and attorney

⁵ The taxpayer had reserved the mineral rights in selling some of its real estate and authorized its officers to execute oil and gas leases but in 1927 when they ratified the release of the reserved rights in certain land for \$2,940, they resolved to make no more such releases "for the present, at least." (R. 15, 89.)

\$33,306.88 and \$250 for negotiating the lease and preparing the instrument, respectively, and received income from all of its leases and declared dividends in each of the years 1938, 1939 and 1940. (R. 16-17, 55, 84, 86-87, 100-112.) As the Board stated, these later activities showed that the company was ready to do whatever business came its way.

All of the foregoing business operations and activities are shown by the evidence. Thus, the Board's findings as to the taxpayer's activities in the year ended June 30, 1938 (R. 17), were supported by substantial evidence (R. 45-117). Under the regulations and the decided cases, these activities were sufficient to constitute carrying on or doing business.

The taxpayer's purposes of organization and activities, apart from the claimed liquidation aspects of the case dealt with hereafter, unquestionably constituted "carrying on or doing business" within the meaning of the law. Since the first decisions under the 1909 tax on the incomes of corporations "carrying on or doing business", it has been recognized that companies engaged in selling, leasing, and managing real estate are taxable. *Flint v. Stone Tracy Co.*, 220 U. S. 107, 169-171⁶; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503; *Page v. M. Rich & Bros. Co.*, 99 F. 2d 607 (C. C. A. 5th), certiorari denied, 306 U. S. 662; *Harmar Coal Co. v. Heiner*, 34 F. 2d 725, 727 (C. C. A. 3d), certiorari denied, 280 U. S. 610; *United States v. Peabody*

⁶ A number of the parties to the group of cases passed upon in the opinion in the *Flint v. Stone Tracy Co.* case were real estate corporations.

Co., 104 F. 2d 267 (C. C. A. 6th). The taxpayer's activities here had declined as it disposed of its holdings, but it had not ceased the activities for which it was organized. It should be noted that the taxpayer apparently concedes (Br. 24, 29-30) that it was realizing profits from investments.

It is thus clear that since the corporation was organized for profit and was still carrying out the purpose of its organization and had branched into new activities for profit, it was "carrying on or doing business". (See Article 42, Treasury Regulations 64, Appendix, *infra*.) It was also engaged in activities ordinarily carried on for profit, such as the leasing, management and sale of properties. (Articles 42-43.)

It has been frequently declared that the statute "requires no particular amount of business in order to bring a company within its terms". *Von Baumbach v. Sargent Land Co.*, *supra*, p. 517; *Page v. M. Rich & Bros. Co.*, *supra*, p. 610; *Argonaut Consolidated Mining Co. v. Anderson*, 52 F. 2d 55 (C. C. A. 2d), certiorari denied, 284 U. S. 682; *American Investment Securities Co. v. United States*, 112 F. 2d 231 (C. C. A. 1st); *Chevrolet Motor Co. v. United States*, 64 C. Cls. 211, 222; cf. *Edwards v. Chile Copper Co.*, 270 U. S. 452, 455-456 (holding that a taxpayer's entire business purposes, activities and situation must be judged together, and in so doing therein, the taxpayer's merely obtaining money through bond issues and advancing it to its subsidiaries or placing it on call loans constituted doing business and therefore was subject to capital stock tax under the Revenue Acts of 1916 and 1918). In the cases cited the quantity of business carried on by the corporations in-

volved was not substantial, and was fairly comparable to the activities of the taxpayer here. Thus, in the *Von Baumbach* case the corporation had leased its mineral lands, received the rentals, employed another company to inspect the properties for it, and sold and rented certain minor portions of its other real estate. The Court stated (p. 516) :

They were organized for the purposes stated, and their activities included something more than the mere holding of property and the distribution of the receipts thereof. * * *

In the *Chevrolet Motor Co.* case, the court stated (p. 222) :

It is not the volume of business done, although in this case that is a most significant factor, but the real intent and purpose of the activities of the corporation and those engaged in its management and conduct. * * *

The present case is not governed by the regulation (Article 43 (b) (1) and (2))⁷ holding the tax inapplicable to corporations engaged in the mere ownership and holding of property and the distribution of the avails, or by decisions holding that a corporation owning or leasing property and doing nothing but distributing the proceeds therefrom to its stockholders is not to be regarded as engaged in business. *Zonne v. Minneapolis Syndicate*, 220 U. S. 187; *McCoach v. Minehill & S. H. R. Co.*, 228 U. S. 295; *United States v. Emery*, 237 U. S. 28.⁸ The *McCoach* case, in which a divided court apparently extended this doctrine to such acts necessary

⁷ See Appendix, *infra*, pp. 25-26.

⁸ The cases cited arose under the 1909 Act.

to the maintenance of the property as the investment and reinvestment of the rentals, seems to have been limited to its facts by many subsequent decisions. Cf. *Von Baumbach v. Sargent Land Co.*, *supra*; *Edwards v. Chile Copper Co.*, *supra*; *United States v. Hercules Mining Co.*, 119 F. 2d 288 (C. C. A. 9th), certiorari denied, 314 U. S. 658; *United States v. Hotchkiss Redwood Co.*, 25 F. 2d 958 (C. C. A. 9th); *Commissioner v. Boeing*, 106 F. 2d 305, 309 (C. C. A. 9th); *United States v. Trust No. B. I. 35, Etc.*, 107 F. 2d 22 (C. C. A. 9th) (where this Court held that the activities of collecting, caring for and disposing of oil from oil leases conducted through an agent, constituted doing business for profit); *Porter v. Commissioner*, 130 F. 2d 276 (C. C. A. 9th); *Argonaut Consolidated Mining Co. v. Anderson*, 42 F. 2d 219, 221 (S. D. N. Y.), affirmed 52 F. 2d 55 (C. C. A. 2d), certiorari denied, 284 U. S. 682; *Page v. M. Rich & Bros. Co.*, 99 F. 2d 607 (C. C. A. 5th), certiorari denied, 306 U. S. 662; *United States v. Peabody Co.*, 104 F. 2d 267 (C. C. A. 6th). In any event the activities of the taxpayer here in selling, renting, and managing real property and the making of oil leases for cash and for present and future royalties, go considerably further than the mere receipt and investment of the proceeds involved in the *McCoach* case.

Subsequent decisions have required very little activity in addition to the holding of property and distribution of the proceeds to bring a corporation within the tax. The test which these cases establish has been sum-

marized by Judge Learned Hand in the *Argonaut* case as follows (p. 56):

Just what activities bring a corporation within the statutory definition the decisions, as is almost inevitable, do not certainly declare. That there is a degree of quietude which will exempt it, is indeed well settled [*Zonne v. Minneapolis Syndicate*, 220 U. S. 187, 31 S. Ct. 361, 55 L. Ed. 428; *McCoach v. Minehill, etc., Co.*, 228 U. S. 295, 33 S. Ct. 419, 57 L. Ed. 842; *U. S. v. Emery, etc., Co.*, 237 U. S. 28, 35 S. Ct. 499, 59 L. Ed. 825; *Eaton v. Phoenix Securities Co.*, 22 F. (2d) 497 (C. C. A. 2); *Rose v. Nunnally Co.*, 22 F. (2d) 102 (C. C. A. 3)]; but how far it may be active and still maintain its exemption, is in the nature of things impossible of statement in general terms. In most of those cases in which the corporation has succeeded its activities have been confined to holding the title of property, whose usufruct it receives and distributes in dividends. When this is the whole scope of its dealings, it does no business within the meaning of the statute.

However, it takes little to bring it from behind this shield. Thus, selling and leasing land, and exploring for ore, were enough in *von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 37 S. Ct. 201, 61 L. Ed. 460; and borrowing money to assist the subsidiary in *Edwards v. Chile Copper Co.*, 270 U. S. 452, 46 S. Ct. 345, 70 L. Ed. 678. On the other side the investment of its funds in current securities from which income is derived was not enough in *McCoach v. Minehill, etc., Co.*, 228 U. S. 295, 33 S. Ct. 419, 57 L. Ed. 842.

The test to be applied is, whether a corporation is (*id.*, at 57) “outside the class of those inert companies, which can assert that they are mere dry holders of property, and conduits to carry over its profit to the persons eventually entitled.” See also *American Investment Securities Co. v. United States*, 112 F. 2d, at 233.

The activities and expenditures of the taxpayer as outlined above clearly show that it does not come within the class of “inert” or “dry holders of property” which are exempt from the law. Rather, as stated in *Edgar Estates Corp. v. United States*, 65 C. Cls. 415, 423—

If the corporation was pursuing the object for which it was organized and doing all the essential things to accomplish that object, it can not claim a classification of an inactive corporation * * *.

Finally, the taxpayer’s erroneous contention that it was not doing business during the critical period herein was aptly answered by this Court in a somewhat comparable situation in *United States v. Trust No. B. I. 35, Etc., supra*, as follows (p. 26):

A further false premise is that the owner of oil land, some leased and some free to lease, with oil sands developed at a certain depth and (in Kern County) the contemplated possibility of still deeper deposits, is not engaging in a productive business for profit when its lessee extracts the oil, but is merely liquidating its capital investment. To state the proposition is to refute it. * * *

(b) Even if the taxpayer merely intended to maintain and preserve its properties with the intention of liquidating them, it was nevertheless carrying on and doing business for profit and therefore taxable

The taxpayer further contends, substantially, that its activities during the year ended June 30, 1938, comprised merely isolated transactions, not for the purposes for which it was organized, but rather reasonably related to the maintenance and preservation of its properties and the orderly disposal and liquidation thereof as rapidly as conditions reasonably warranted, and therefore it is not subject to the tax in question. (Br. 47-72.)

Even if the taxpayer intended to liquidate over a long period of time and carried on its business activities with that end in view, the fact nevertheless remains that corporate activities consisting of liquidation of assets do not mean that it is not engaged in business. In a sense, every mining or other wasting-asset corporation is engaged in the liquidation of its assets.⁹ The real question, we submit, is not whether a corporation *intends* to continue doing business after the property presently owned is disposed of, but whether it *is* doing business at the time it is disposing of the property. The nature of the activities during the taxable period, not the intention as to what the corporation will or will not do in the future, must be controlling. We have al-

⁹The taxability of a wasting-asset corporation is clear. Cf. *Harmer Coal Co. v. Heiner*, 34 F. 2d 725 (C. C. A. 3d), certiorari denied, 280 U. S. 610; *United States v. Hercules Mining Co.*, 119 F. 2d 288 (C. C. A. 9th), certiorari denied, 314 U. S. 658; *Lyon Lumber Co. v. Harrison*, 113 F. 2d 443 (C. C. A. 7th).

ready shown heretofore that, under the authorities and the pertinent regulations, the taxpayer was actually doing business during the critical period.

Moreover, if in addition to the business activities carried on by the taxpayer, it was also engaged in liquidation at the same time, then the regulation specifically provides that any activities it engaged in towards the orderly liquidation of its property by negotiating sales from time to time as opportunity and judgment dictated and the distribution of the proceeds as the liquidation was effected, constituted "doing business" within the meaning of the statute. Art. 43 (a)(5), Treasury Regulations 64 (1938 Ed.), *infra*. It is settled that this regulation is valid and must be given effect. *Magruder v. Washington, B. & A. Realty Corp.*, *supra*.

The Board correctly held that the taxpayer's argument is concluded by that case, regardless of whether or not earlier cases held to the contrary. (R. 17-18.) There, the corporation was formed for the purpose of liquidating the properties in question, formerly belonging to a defunct corporation. The Court, holding valid and applying the above regulation, concluded that the taxpayer was actively engaged in fulfilling the purposes of its creation—liquidation of its holdings for the best obtainable price—and therefore it was carrying on and doing business within the meaning of Section 105 (a) of the 1935 Act (identical with Section 601 (a) of the 1938 Act herein, except for years and amounts). Consequently, the Court upheld the imposition of the capital stock tax for the years 1936-1939 and denied the refund claimed by the taxpayer.

The taxpayer contends that the Board misinterpreted and misapplied the decision in that case to the facts herein on the ground that the regulations (Art. 43 (b) (2), Treasury Regulations 64 (1938 Ed.)) exempt from tax a corporation which is merely holding property, distributing its avails, and maintaining its corporate status, whether the corporation was organized for such purposes or has reduced its activities to the mere owning and holding of the property and the distribution of the avails thereof. (Br. 40-45). We have already shown, however, that the taxpayer was formed for the purpose of, and was actually, carrying on and doing business for profit and that instead of merely holding property, the business activities and profits were increasing during the taxable year 1938. *Continental Baking Corp. v. Higgins*, 130 F. 2d 164 (C. C. A. 2d), the principal case relied upon by the taxpayer (Br. 44-45), is distinguishable for somewhat the same reasons that the Court found it distinguishable from *Magruder v. Washington, B. & A. Realty Corp., supra*. There, the activities of the taxpayer—sale and exchange of its own and its subsidiary's stock in order to liquidate and eliminate an intermediate holding company as a step in its plan of consolidation—were, unlike the taxpayer's herein, “only those of a quiescent holding company such as fall within the exceptions set forth in Treasury Regulations 64, Article 43 (b), (2), and not within Article 43 (a), (5), as did those dealt with in *Magruder, Collector v. Washington, B. & A. Realty Corp., supra*.” (P. 167.)

In view of the foregoing, we submit that under the facts herein the taxpayer was clearly engaged in, carry-

ing on and doing business within the meaning of Section 601 (a) of the 1938 Act, rather than merely performing incidental and isolated transactions necessary for the preservation and liquidation of its properties. It is therefore liable for the tax imposed under Section 602 (a) of that Act for the taxable year 1938, as the Board held.

CONCLUSION

The decision of the Board of Tax Appeals is correct and in accord with law and the authorities. It should therefore be affirmed.

Respectfully submitted,

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DECEMBER, 1942.

Argued by Mr. Rockwell

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 601. CAPITAL STOCK TAX.

(a) For each year ending June 30, beginning with the year ending June 30, 1938, there is hereby imposed upon every domestic corporation with respect to carrying on or doing business for any part of such year an excise tax of \$1 for each \$1,000 of the adjusted declared value of its capital stock.

* * * * *

SEC. 602. EXCESS-PROFITS TAX.

(a) If any corporation is taxable under section 601 with respect to any year ending June 30, there is hereby imposed upon its net income for the income-tax taxable year ending after the close of such year, an excess-profits tax equal to the sum of the following:

“6 per centum of such portion of its net income for such income-tax taxable year as is in excess of 10 per centum and not in excess of 15 per centum of the adjusted declared value;

“12 per centum of such portion of its net income for such income-tax taxable year as is in excess of 15 per centum of the adjusted declared value.”

* * * * *

Treasury Regulations 64 (1938 Edition), relating to the Capital Stock Tax:

ARTICLE 1. *Effective date of the tax.*—The capital stock tax imposed by section 601 of the Revenue Act of 1938 is in effect on and after July 1, 1937, and applies with respect to each

year ending June 30, beginning with the year ending June 30, 1938.

ART. 41. *Nature and rate of tax.*—The tax is an excise tax imposed with respect to carrying on or doing business during a taxable year ending June 30, or any fractional part thereof. It is an excise tax upon the exercise of the privilege of doing business and not upon the business itself and is imposed upon each corporation with respect to carrying on or doing business and not upon each business carried on. If more than one corporation is engaged in carrying on a single business, each must file a return and pay the tax. The tax is imposed at the rate of \$1 for each full \$1,000 of the adjusted declared value of the capital stock. The tax may not be apportioned under any circumstances. If a corporation is engaged in business for any portion of a taxable year, liability for the tax is incurred for the entire taxable year.

ART. 42. *Doing business.*—The term “business” is very comprehensive and embraces whatever occupies the time, attention, or labor of men for profit. Accordingly, regardless of the nature of its activities, any corporation organized for profit and carrying out the purpose of its organization is doing business within the meaning of the Act. Similarly, even if not organized for profit, any corporation which engages in activities ordinarily carried on for profit is doing business. It is immaterial whether the activities result in a profit or a loss, or whether the corporation has been successful in its enterprise, or that because of unfavorable business conditions, no operations are carried on for a particular period. No particular amount of business need be done, nor is it necessary that the business be continuous throughout the taxable year.

The case is exceptional in which the activities of a corporation organized for profit do not amount to doing business within the meaning of the Act. Such a case is generally limited to one

in which the corporation is not pursuing the ends for which organized, i. e., profit.

ART. 43. *Illustrations*.—(a) *General*.—In general “doing business” includes any activities of a corporation whether it engages in—

* * * * *

“(3) leasing or managing properties, collecting rents or royalties;

* * * * *

“(5) the orderly liquidation of property by negotiating sales from time to time as opportunity and judgment dictate and distribution of the proceeds as liquidation is effected—for example, the liquidation of an estate, or of properties taken over from another corporation, or of the shareholders’ fractional interests in particular property;

* * * * *

“(7) leasing all its properties to another without divesting itself of all control and management of the properties under such terms that it keeps the properties in repair, or engages in other activities necessary to enable the lessee to utilize the leased properties, regardless of whether such activities are performed on behalf and under the order of the lessee or whether such acts are of major importance; or

“(8) any other activities coming within the ordinary and natural signification of the term ‘carrying on or doing business’.”

(b) *Exceptions*.—Ordinarily the exceptions to “doing business” are restricted to limited activities of a corporation. For example—

(1) A corporation is not subject to the tax if its corporate powers are limited to the mere owning and holding of property and the distribution of its avails, or, although incorporated for the purpose of doing business, if it has retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, the distribution of its avails,

and doing only such acts as are necessary to the maintenance of its corporate existence and the private management of its purely internal affairs. However, a corporation which has retired from its principal business is subject to the tax if, nevertheless, it engages in other business activities or maintains its organization for the purpose of continued effort in the pursuit of profit or gain.

(2) A corporation may complete its organization and sell its capital stock for cash without incurring liability. However, the exchange of its capital stock for property other than cash or the use of the proceeds from the sale of its capital stock for the purchase of property are corporate business acts and constitute doing business. Entering into contracts for the purchase of property or the construction of a plant are also corporate acts and constitute doing business. In other words, it is not necessary that a corporation be actually engaged in the manufacture of its intended product or that it be actually creating profit or gain to incur liability, since making contracts, buying materials or machinery, and employing and discharging individuals are necessary business acts leading to the ultimate attainment of the objects and purposes for which the corporation was created and has its existence.

(3) A corporation will not be regarded as "doing business" if it had no activities during entire taxable year, because it has—

"(a) become dormant; or

"(b) completed its business, as, for example, where a real estate subdivision has been developed, sold and reduced to cash; or

"(c) abandoned its business, as, for example, where prospective oil properties are proven worthless"

ART. 44. *Declared value.*—In its return for each declaration year, a corporation must declare a definite and unqualified value for its

capital stock. The declaration of value must be made in terms of United States dollars and be specific, as, for example, \$10,000, or "Zero," in the event it is desired to indicate no value. Inasmuch as the declared value can in no case be less than zero, a declaration of a deficit or minus figure shall be considered a declaration of "Zero."

* * * * *

For the declared value of corporate capital stock referred to in Article 44, *supra*, and the declared value excess-profits taxes regulation relating to the excess-profits taxes imposed by Section 602 of the Revenue Act of 1938, see T. D. 4829, 1938-2 Cum. Bull. 98.







